# Report on the Feasibility of an Ontario Insurance Exchange

by The Ontario Insurance Exchange Advisory Committee

September 1983

Ontario
Ministry of Consumer and Commercial Relations

Ontario

Ministry of Consumer and Commercial Relations

Insurance Exchange Advisory Committee

555 Yonge Street
7th Floor
Toronto Ontario
M7A 2H6
416/963-2510



The Honourable Robert G. Elgie, M. D.
Minister of Consumer and Commercial Relations
Ontario

Sir:

We have the honour to present to you the Report of the Advisory Committee on the Feasibility of the Creation of an Insurance Exchange in Ontario.

We record with deep sorrow the untimely death on June 18th, 1983 of Mr. Harley Vannan, a distinguished and highly respected insurance executive. He made a very valuable contribution to our deliberations and his passing represents a great loss to our Committee and to the whole insurance industry.

Robert H. Hilborn, Chairman

William G. Munro

Daniel Damov

Jean Robitaille

Cedric G. E. Gyles

Richard M. Willemsen

Bruce R. Harvey

Murray A. Thompson, Q. C.
Superintendent of Insurance

David B. Horsley, Q. C.

Dagmar A. Stafl
Research Director and Secretary to the Committee

Dr. Rolf R. Kern

William B. Laur
Recording Secretary

Huntly W. F. McKay

Toronto, September 30, 1983

STATEMENT

IN THE LEGISLATIVE ASSEMBLY OF THE PROVINCE OF ONTARIO

BY

THE HONOURABLE ROBERT G. ELGIE, M.D.

MINISTER OF CONSUMER AND COMMERCIAL RELATIONS

ON

THE INSURANCE EXCHANGE

NOVEMBER 4, 1982

Mr. Speaker, I am pleased to announce today a rather exciting initiative. Cabinet has approved in principle the establishment of an insurance exchange in Toronto. In preparation for that event I will be appointing a committee to study the proposal and to prepare an implementation plan within six months.

We are indeed fortunate that an individual with a distinguished career in the insurance industry, Colonel Robert Hilborn, has agreed to serve as chairman of that committee. Colonel Hilborn is here with us today in the Speaker's gallery and I would ask that he stand and be recognized.

Colonel Hilborn brings more than 20 years of senior level experience in the insurance industry to this position. He has long been recognized at both the underwriting and brokerage levels as a leading spokesman and educator for the surety industry in Canada and the United States. He served as the first Canadian president of the National Association of Surety Bond Producers in Washington in 1973-74, and was also a director of the Toronto Insurance Conference.

Under Colonel Hilborn's direction, the main work of the committee will be to review and report on experiences in other jurisdictions where insurance exchanges operate; to invite comments from informed members of the industry and financial community on the concept of an Ontario insurance exchange; and to consider the tax, legal and Federal Investment Review Agency implications for the establishment of an insurance exchange.

The objective of the committee will be to submit a detailed plan of a legal and marketing framework for a Toronto insurance exchange and its implementation.

As you may already be aware, Mr. Speaker, an insurance exchange is designed to provide a centralized market facility where the risks associated with insuring a high-risk enterprise are shared by member

underwriters for a price negotiated on the floor of the exchange. The idea is not a new one: Lloyd's of London has operated successfully as such an exchange for the past 290 years. It is a place where large risks can be shared, difficult risks placed and new and unusual risks covered by insurance.

In the United States, a determined effort has already been made to recapture premium dollars going abroad. An insurance exchange was established in New York in 1980 to provide U.S. insurers with an alternative to Lloyd's of London. Another exchange was established in Chicago in 1981 and a third is now planned for Miami. The reason is simple. A local insurance exchange helps reduce the tremendous outflow of insurance premium dollars to foreign markets.

In Canada alone, we estimate that more than $1 billion worth of direct and reinsurance premiums leave the country annually. In addition, many general insurance risks of a large nature are placed outside Canada on either the Lloyd's market or the New York market. For example, one of the first items of business on the New York Insurance Exchange was the insurance for the Alberta pipeline project.

Establishing an insurance exchange in Ontario should in time reduce this huge outflow of Canadian dollars and at the same time strengthen Toronto's position as a major financial centre, raise the visibility of Canadian insurance companies and attract fresh investor capital. I perceive such an exchange operating as a self-regulating group with a minimum of government regulation, another example of how government and industry can work together.

TERMS OF REFERENCE

The Consultant will chair an Insurance Exchange Committee, which will,

1. determine the size of the reinsurance market and the amount of direct insurance and reinsurance that is placed with insurers outside Canada;

2. review and report on present practices of insurers seeking reinsurance;

3. review and report on the present practices of brokers placing coverages for general insurance outside of Ontario;

4. review and report on experience in other jurisdictions where an Insurance Exchange operates;

5. invite comments from informed members of the industry and financial community on the concept of an Ontario Insurance Exchange;

6. consider the tax, legal and FIRA implications for the establishment of Insurance Exchange;

7. determine the capital requirements and sources of capital

   (a) for physical facility and operations and
   (b) for funding of the risk traded at the Insurance Exchange;

8. consider how to attract Canadian capital into the insurance marketplace;

9. consider whether non-residents should be eligible for membership in the Insurance Exchange;

10. consider whether all reinsurance should be placed through the Insurance Exchange;

11. report whether the membership on the Insurance Exchange should be subject to licensing requirements;

12. make recommendations as to the feasibility and the potential benefits of the project; and

13. submit a legal and marketing framework of an Insurance Exchange subject to committee's recommendation to proceed with the establishment of an Insurance Exchange.

# PREFACE

Before we embark on the substance of this report, we would like to express our thanks to the many individuals and organizations without whose help completion of the report within the time and budget available to us would have been impossible.

We requested assistance from more than fifty senior executives and professionals who are actively engaged in the fields of insurance, finance, law and accounting, to serve on five subcommittees. These subcommittee members have dedicated many hours of work to their assignments resulting in a valuable contribution to our deliberations and to the final report. The names of the subcommittee members are shown in Chart 1.

Associations and individuals interest in the concept of an insurance exchange kept in touch with the Committee throughout its deliberations and their interest and comments were noted and appreciated.

We wish to recognize the cooperation received from Mr. Donald E. Reutershan, President of the New York Insurance Exchange, Mr. James M. Skelton, Executive Director of the Illinois Insurance Exchange, and Mr. Alan Teale, President of the Insurance Exchange of the Americas and members of their staffs who have been very helpful in sharing their experience with us and in providing advice and data.

We are grateful for the information, advice and counsel received at meetings with Mr. J. Arthur Madill, Attorney in Canada for Lloyd's; the two broker Governors of the NYIE, Mr. David Winton of Johnson & Higgins and Mr. David Holbrook of Marsh & McLennan, and Mr. Richard Stewart of Stewart Economics, a former New York State Superintendent of Insurance and, from 1979 to mid-1981, a founding Governor of the NYIE.

We also wish to recognize the valuable assistance of Mrs. Elizabeth Morgan, Ministry librarian and Miss Leilah Pohl, who as Secretary to the Chairman typed the report and provided support services to the Committee.

The total experience has been a most heartening one for the Committee members and the support staff. It has demonstrated how the community can be served through the mutual efforts of the private and public sectors in seeking new approaches to the challenges facing the insurance industry and its role in the economy.

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CHAPTER 1

INTRODUCTION - BACKGROUND

## The Insurance Exchange Concept

In the beginning was Lloyd's of London -- since the seventeenth century the world's first and only insurance exchange until the New York Insurance Exchange was established in 1980. New York was followed closely by the Illinois Insurance Exchange in Chicago in 1981 and in 1983, the Insurance Exchange of the Americas opened in Miami, Florida.

All of these exchanges are associations of insurance brokers and underwriting syndicates. Each is a centralized market facility through which reinsurance and large, complex and unusual insurance risks are placed by brokers with underwriting syndicates who are prepared to subscribe to a share of a risk for a price negotiated on the floor of the exchange. Brokers represent insurance buyers seeking the best terms for their clients' risks from the underwriting syndicates. In the United States' Exchanges, the syndicates are composed of corporate and individual investors who are generally silent partners and in most cases, but not necessarily, insurance related. The business of the syndicates is managed by underwriting managers.

The exchange itself does not underwrite risks or transact insurance business. It is a management and administrative service operation that provides the facilities for issuing policies; clearing, collecting and settling claims for the members of the Exchange; reporting transactions between brokers and syndicates, and data collecting. An insurance exchange operates under a set of rules established by a governing body elected by the members of the exchange. The rules of the exchange govern the financial activities of its members and ensure that they meet their financial obligations.

## Report of the Select Committee on Insurance Industry in Ontario

In 1979 the Select Committee on Company Law reported on the insurance industry in Ontario. In its Third Report under Chapter 8 -- "Capacity: The Ability of the General Insurance Industry to Under-

write All Risks",[1] the Committee states that to achieve utilization of total capacity, the insurance industry must make use of the following mechanisms:

- reinsurance
- joint underwriting
- residual market mechanisms
- subscription policies and layering
- Insurance Exchanges

The Select Committee found that, with the exception of the Insurance Exchange concept, the industry has made extensive use of all of the above mechanisms for capacity utilization.

The Select Committee set out the following guidelines for the insurance industry to demonstrate its willingness to act in the best public interest:

(a) Seek out the most efficient mechanisms for utilization of capacity.

(b) Seek out new and innovative methods of bringing together buyers and sellers of insurance.

(c) Demonstrate a reasonably representative presence throughout the province.

(d) Avoid mechanisms which charge rates for risks rejected by the voluntary market on an entirely different rate structure from that in the voluntary market.

The Select Committee concluded that: "In keeping with the above guidelines, the industry is encouraged to explore the concept of an Insurance Exchange that brings together insureds, or their brokers, with skilled underwriters and insurers. Such a concept has come to the Committee's attention in regard to the recently approved New York Insurance Exchange."[2]

## The Changing Insurance Environment

The simple divisions of risk and the law of averages remain the bases of the insurance industry, despite the complexities inherent in today's risk environment. Complex technologies, high loss frequencies

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[1] The Select Committee on Company Law: The Insurance Industry Third Report on General Insurance, Chapter 8.

[2] Supra p. 139

and increasingly litigious claimants at a time of economic uncertainty, affect exposure to risk and the demand for protection against risk to a greater extent than at any time in recent history. While the basic insurance product has not changed, its application and its distribution through the development of new marketing mechanisms have altered in response to changing economic conditions, an increasingly selective clientele and a highly competitive world-wide marketplace.

New ideas are the key to the continuing strength and growth of the insurance industry in Ontario and in Canada generally. Insurance underwriting and broking operate in an international market and must follow the movement of commerce around the world. The Canadian insurance industry must ensure that it has the capacity, knowledge and facility, not only to serve our own country, but to reach beyond its boundaries. Securities and commodities have long been traded on Canadian exchanges, but the Canadian insurance industry can turn only to London and other world financial centres for a similarly efficient way of doing business.

John B. Cox, Chairman of the Insurance Company of North America, speaking at the International Insurance and Risk Management Conference in West Berlin, on October 28, 1982, said: "The capabilities of the insurance industry in the year 2,000 will be challenged as never before by the exponential rate of turbulence in the economic, social and political environments of the twenty-first century ... if the insurance business is to grow and thrive and live and prosper, provincial barriers must fall. Governments and society must provide a felicitous environment. And, the industry itself must accept and embrace change. For change is evidence of life."

The insurance industry should respond with changes that are fundamental in nature, instead of being related merely to an industry cycle. The response of the Ontario government in support of the insurance industry was to give approval in principle to the establishment of an Insurance Exchange and to initiate a feasibility study.

The Insurance Exchange Advisory Committee was formed to determine the feasibility of an Insurance Exchange in Ontario as a commercial venture and, if recommended, the minimum conditions essential for its success. The Committee's objective is to develop the focus an Insurance Exchange should have and to detail the conditions required to enable it to compete successfully for business and for capital. This is a positive approach in the spirit of the assignment given to it.

## Composition and Tasks of Advisory Committee and Subcommittees

In addition to the Advisory Committee, five Subcommittees were formed to study specific tasks. The rationale behind the composition of both the Advisory Committee and the Subcommittees was that they must

be working committees and not representational, as the tasks before them could only be accomplished through information gathering and analysis by individuals in the insurance industry and related professions closest to the areas being examined, e.g. Lloyd's, the U.S. Exchanges, principally New York, and other reinsurance marketplaces. In every case, individuals from the insurance industry and the legal and accounting professions were sought for their expertise and not as representatives of the organizations or associations to which they belong. All subcommittee members were selected by a consensus of peers on the basis of their specialized experience and knowledge to focus on the question of the feasibility of an Insurance Exchange through the tasks assigned. It is evident that all members saw themselves in this role and not as representatives of a particular constituency or interest group.

The five Subcommittees were formed to study specific tasks:

Underwriting Subcommittee

- Determine the size of primary and reinsurance markets and describe the present practices of placing large, unusual and specialty risks.
- Determine the effect on capacity of cycles in the industry.
- Determine what proportion of reinsurance is placed through head offices of non-Canadian companies and what proportion is placed through their Canadian offices.
- Examine the domestic capacity for Canadian insurance needs.
- Examine the classes of insurance and types of risks to be placed on an insurance exchange.
- Examine the ability of the insurance industry to provide the expertise and skills required in the operation of an exchange.
- Determine the general reaction of underwriters to the establishment of an insurance exchange.

Brokers and Insureds Subcommittee

- Determine the present practices of brokers placing insurance for Canadian risks outside Canada.
- Determine the participation and role of the broker in an insurance exchange.
- Examine the self-regulatory aspects of an insurance exchange.

- Examine the expertise and facilities to be provided by an insurance exchange.

- Determine the reaction of major insurers to the establishment of an insurance exchange.

Finance and Capital Subcommittee

- Examine the methods of financing other insurance exchanges.

- Determine capital requirement and sources of capital:

    - for syndicate capitalization

    - for guaranty fund

    - for physical facilities and operations

- Determine the reaction of the financial community to the establishment of an insurance exchange.

Tax and Legal Subcommittee

- Examine the federal and provincial tax implications relevant to the creation of an insurance exchange.

- Examine the legal framework for the establishment of an insurance exchange, giving consideration to the present legal structures governing the insurance industry.

- Examine the legal considerations of syndicate formation on the Exchange.

Membership and Marketing Subcommittee

- Determine - categories of membership

    - ways of attracting membership

    - potential for private investments

    - licensing requirements

    - eligibility of non-residents

- Examine the rules governing membership.

The Chairman maintained a close liaison with the Subcommittees as did members of the Advisory Committee, two of whom related to each of the Subcommittees in a liaison and consulting role. The Chairmen of the Subcommittees communicated periodically to keep abreast of the work in progress in all committees, thus avoiding unnecessary duplication of assignments. However, Subcommittees were encouraged to explore the same topics from different perspectives. This cooperative approach to the study and the coordination of tasks proved to be both efficient and effective.

The Advisory Committee recognized in the early stages of its deliberations that the assignments had to be dealt with in two stages because of their complexity and the time constraints involved. Many of the tasks, especially in the tax, legal and finance areas could be addressed initially only in outline indicating the advantages and disadvantages of alternative courses of action without providing a detailed legal and financial framework.

The Advisory Committee spent considerable time on collecting data and gathering opinions and information from Canadian, British and American sources. It decided to address and study each assignment in the broadest sense consistent with arriving at firm conclusions and recommendations. Despite being confronted frequently with provisos and conditional responses the Committee considers this Phase I Report to be a true evaluation of the climate in which an Insurance Exchange can be established successfully.

CHART: 1

## INSURANCE EXCHANGE ADVISORY COMMITTEE

| | |
|---|---|
| Robert H. Hilborn: | Chairman |
| Dagmar A. Stafl (Mrs.): | Research Director and Secretary to the Committee |
| Daniel Damov | William G. Munro |
| Cedric G.E. Gyles | Jean Robitaille |
| Bruce R. Harvey | Murray A. Thompson Q.C. |
| David B. Horsley Q.C. | Harley B. Vannan* |
| Rolf R. Kern | Richard M. Willemsen |
| Huntly W.F. McKay | |

* Died in June 1983

### SUPPORT STAFF

William B. Laur:
Recording Secretary
Leilah Pohl
Secretary to the Chairman

### SUBCOMMITTEES

| UNDERWRITERS | BROKERS AND INSUREDS | TAX AND LEGAL | FINANCE AND CAPITAL | MEMBERSHIP AND MARKETING |
|---|---|---|---|---|
| - Rolf R. Kern<br>Jean Robitaille | - Cedric G.E. Gyles<br>Bruce R. Harvey | - David B. Horsley<br>William G. Munro | - Daniel Damov<br>Huntly W.F. McKay | - Harley B. Vannan<br>Richard M. Willemsen |
| Harry J. Saunders: Chairman | William E. Toyne: Chairman | David H. Atkins: Chairman | Robert J. McCormick: Chairman | Gordon A. Chellew: Chairman |
| C. Brennan | John F. Caird | Ronald C. Brown | Melville J. Binnington | Harold K. Ballantyne |
| Richard W. Broughton | Keith S. Exon | David G. Ford | David H. Brown | John D. de Pencier |
| Peter Eastwood | Richard M. Gardner | Kenneth R.M. Hennessy | John A. Moir | John Johnstone |
| Sidney Gordon | Bryce M. Hunter | Randall W. Legallais | John C. Mueller | Brian W. Jones |
| Kenneth J. Mead | John C. Meen | Robert W. McDowell | David P. Ross | Peter E. Reeve |
| John R. Soper | Alfred Parke | Barry J. Olivella | Michael J. Ross | Claud R. Smith |
| William W. Ward | Lorne Philpott | C. John Stubbs | Robert A. Whiklo | |
| Donald A. Waugh | William H. Whiteside | William R. Waters | | |
| | Donald A. Whitmore | Robert Wylie | | |

CHAPTER 2

# SIZE OF THE GENERAL INSURANCE MARKET IN CANADA

The premium income volume generated by primary insurance and reinsurance and its subsequent investment are significant factors in the Canadian economy. In 1981 the total premiums written by property and casualty insurers amounted to over $8 billion. This includes business written by federally and provincially licensed companies and four provincial government insurance operations: Insurance Corporation of British Columbia (ICBC); Saskatchewan Government Insurance (SGI); Manitoba Public Insurance Corporation (MPIC); and the Régie de l'Assurance l'Automobile du Quebec (RAAQ).

Federally registered companies wrote 70 percent of the total premiums, provincially licensed companies and provincial government insurance operations shared the balance of the business equally. (Table 1).

Tables 2, 3, 4 and 5 show direct premiums written by insurance categories and by group of registrants: Canadian, British and foreign.

Table 1: Property and Casualty Insurance Companies in Canada - Premiums Volume, 1981

| Direct Premiums Written* by: | | 1981<br>$ Million |
|---|---|---|
| Federally registered** | | |
| Canadian Companies | 4,153 | |
| British Companies | 432 | |
| Foreign Companies | 1,144 | |
| Sub Total | | 5,721 |
| Provincially licensed (all Provinces) | | 1,259 |
| Provincial Government Insurance Operations (ICBC; SGI; MPIC; RAAQ) | | 1,243 |
| Total | | 8,223 |

* Includes Marine and Accident and Sickness written by non-life insurance companies.

** The difference of $8 million between the total of $5,721 million reported under Tables 1 and 2 and the $5,729 aggregate of the totals under Tables 3, 4 and 5 relates to varying reporting methods for Canadian companies.

Source: Report of the Superintendent of Insurance for Canada. Abstract of Statements of Property and Casualty Insurance Companies, 1981, pp. 4A, 68D, 69D, 70D, 75D.

Table 2: Property and Casualty Insurance Companies in Canada - Premiums Volume, 1981

| | Direct Premiums Written $'000 | % |
|---|---|---|
| All Companies Federally Licensed: | | |
| Property | 2,269,314 | 39.7 |
| Accident, Sickness | 124,528 | 2.2 |
| Aircraft | 77,217 | 1.4 |
| Automobile - Liability | 1,257,493 | 22.0 |
| - Personal Accident | 121,688 | 2.1 |
| - Other | 1,143,953 | 20.0 |
| Boiler, Machinery | 62,554 | 1.1 |
| Credit | 2,235 | 0.04 |
| Fidelity | 26,977 | 0.5 |
| Hail | 19,712 | 0.3 |
| Legal | 63 | - |
| Liability | 426,861 | 7.5 |
| Mortgage | 25,478 | 0.4 |
| Surety | 84,366 | 1.5 |
| Title | 213 | - |
| Marine | 78,008 | 1.4 |
| Total | 5,720,660 | 100.0 |

Source: Report of the Superintendent of Insurance for Canada, Abstract of Statements of Property and Casualty Insurance Companies, 1981, p. 75D.

Table 3: Property and Casualty Insurance Companies in Canada - Premiums Volume, 1981

| Canadian Companies Federally Registered * | Direct Premiums Written | Reinsurance Assumed | Reinsurance Ceded | Net Premiums Written |
|---|---|---|---|---|
| | | $'000 | | |
| Property | 1,642,314 | 560,011 | 869,399 | 1,332,926 |
| Accident, Sickness** | 85,704 | 16,826 | 22,138 | 80,392 |
| Aircraft | 5,647 | 7,024 | 9,607 | 3,064 |
| Auto - Liability | 972,088 | 254,649 | 292,788 | 933,949 |
| - Personal Acc. | 92,807 | 18,814 | 24,226 | 87,395 |
| - Other | 887,990 | 189,748 | 244,077 | 833,661 |
| Boilers, Machine | 38,949 | 20,670 | 24,112 | 35,507 |
| Credit | 213 | 350 | 470 | 93 |
| Fidelity | 22,657 | 4,466 | 6,801 | 20,322 |
| Hail | 7,215 | 12,355 | 9,899 | 9,671 |
| Legal Expenses | - | 14 | 7 | 7 |
| Liability | 280,757 | 103,780 | 131,818 | 252,719 |
| Mortgage | 25,476 | 101 | - | 25,577 |
| Surety | 63,376 | 24,627 | 47,305 | 40,698 |
| Marine | 27,798 | 24,224 | 23,433 | 28,589 |
| Total | 4,152,991 | 1,237,659 | 1,706,080 | 3,684,570 |

* Includes out of Canada business for some Companies (less than 10% of business)

** Business transacted by life insurance companies is excluded

Source: Report of the Superintendent of Insurance for Canada. Abstract of Statements of Property and Casualty Insurance Companies, 1981, p. 68D.

Table 4: Property and Casualty Insurance Companies in Canada - Premiums Volume, 1981

| British Companies Federally Licensed | Direct Premiums Written | Reinsurance Assumed | Reinsurance Ceded | Net Premiums Written |
|---|---|---|---|---|
| | | $'000 | | |
| Property | 166,367 | 91,512 | 29,495 | 228,384 |
| Accident, Sickness** | 25,200 | 21,530 | 931 | 45,799 |
| Aircraft | 53,775 | 4,533 | 19,917 | 38,391 |
| Auto - Liability | 67,239 | 7,959 | 5,263 | 69,935 |
| - Personal Acc. | 4,648 | 281 | 405 | 4,524 |
| - Other | 70,695 | 5,435 | 4,018 | 72,112 |
| Boiler, Machinery | 667 | 431 | 170 | 928 |
| Fidelity | 1,587 | 307 | 12 | 1,882 |
| Hail | - | 2,933 | - | 2,933 |
| Legal Expenses | 13 | - | 4 | 9 |
| Liability | 32,725 | 5,497 | 4,211 | 34,011 |
| Surety | 134 | 2,275 | 511 | 1,858 |
| Marine | 9,099 | 5,516 | 8,138 | 6,477 |
| Total | 432,149 | 148,209 | 73,115 | 507,243 |

** Business transacted by life insurance companies is excluded

Source: Report of the Superintendent of Insurance for Canada. Abstract of Statements of Property and Casualty Insurance Companies, 1981, p. 69D

Table 5: Property and Casualty Insurance Companies in Canada - Premiums Volume, 1981

| Foreign Companies Federally Registered | Direct Premiums Written | Reinsurance Assumed | Reinsurance Ceded | Net Premiums Written |
|---|---|---|---|---|
| | | $'000 | | |
| Property | 463,778 | 369,958 | 330,141 | 503,595 |
| Accident, Sickness** | 14,357 | 30,031 | 7,412 | 36,976 |
| Aircraft | 18,451 | 12,797 | 23,904 | 7,344 |
| Auto - Liability | 218,427 | 105,423 | 59,767 | 264,083 |
| - Personal Acc. | 24,248 | 6,901 | 4,839 | 26,310 |
| - Other | 185,100 | 73,870 | 51,044 | 207,926 |
| Boiler, Machinery | 23,215 | 16,541 | 15,910 | 23,846 |
| Credit | 2,022 | 25 | - | 2,047 |
| Fidelity | 2,759 | 2,258 | 1,779 | 3,238 |
| Hail | 12,497 | 1,773 | 9,307 | 4,963 |
| Legal Expenses | 17 | 2 | - | 19 |
| Liability | 115,841 | 52,039 | 58,408 | 109,472 |
| Surety | 20,874 | 21,521 | 16,616 | 25,779 |
| Title | 213 | - | 42 | 171 |
| Marine | 42,042 | 8,276 | 34,268 | 16,050 |
| Total | 1,143,841 | 701,415 | 613,437 | 1,231,819 |

** Business transacted by life insurance companies is excluded

Source: Report of the Superintendent of Insurance for Canada. Abstract of Statements of Property and Casualty Insurance Companies, 1981, p. 69D

Ontario licensed property and casualty companies wrote $304 million direct premiums in 1982 in Ontario compared with $250 million in 1981, a 22 percent increase.

Table 6: Ontario Licensed Property and Casualty Companies - Premiums Volume Written in Ontario Only

| | 1981<br>$'000 | 1982<br>$'000 |
|---|---|---|
| Direct Premiums Written: | | |
| Property | 72,558 | 83,996 |
| Accident | 901 | 1,101 |
| Aircraft | 1,771 | 1,880 |
| Auto - all | 141,299 | 173,984 |
| Boilers, Machinery | 2,690 | 2,945 |
| Credit | - | - |
| Fidelity | 245 | 383 |
| Hail | 2,846 | 4,536 |
| Legal Expenses | - | - |
| Liability | 22,982 | 28,906 |
| Mortgage | - | - |
| Surety | 3,085 | 2,629 |
| Title | - | - |
| Marine | 4,016 | 3,766 |
| Total Ontario Only | 250,119 | 304,126 |

Source: Companies' Financial Statements - Preliminary figures for 1982

Volume written and assumed in Ontario and other provinces by Ontario licensed companies rose to $560 million in 1982 from $476 million in 1981, a 17 percent increase.

The companies ceded $345 million to reinsurance in 1982; almost a third to unlicensed reinsurers. In 1981 the amount ceded to unlicensed reinsurers represented only 18 percent of the direct written premiums.

Table 7: Property and Casualty Companies *Ontario Licensed: Premiums Written in Ontario and Other Provinces

| | 1981 $'000 | % | 1982 $'000 | % |
|---|---|---|---|---|
| Direct Premiums Written: | 400,419) | | 493,722) | |
| | ) | 100 | ) | 100 |
| Reinsurance Assumed: | 76,043) | | 66,401) | |
| Reinsurance Ceded | | | | |
| to registered: | 172,602 | 36.2 | 182,982 | 32.6 |
| to unregistered: | 87,950 | 18.5 | 162,513 | 29.0 |
| Total | 260,552 | | 345,495 | |
| Net Premiums Written: | 215,910 | 45.3 | 214,628 | 38.4 |

* Includes: Canadian controlled companies
British controlled companies
Foreign controlled companies

Source: Companies' Financial Statements - Preliminary figures for 1982

The following table gives an overview of direct premium written and reinsurance ceded to registered and non-registered reinsurers.

Table 8: Property and Casualty Companies: Summary of Direct and Reinsurance in Canada Premium Volume Written by Federally Registered Companies and by Ontario Licensed Companies, 1981

| | 1981 | | | | |
|---|---|---|---|---|---|
| | Direct Premiums Written | Reinsurance Assumed | Registered | Non-Reg | Net Premium Written |
| | $ | $ | $ | $ | $ |
| Reinsurance Companies * | | | | | |
| Canadian ** | - | 466,976 | 109,742 | 142,064 | 212,170 |
| British | - | 51,330 | (994) | 4,225 | 48,099 |
| Foreign | - | 249,218 | 3,043 | 40,708 | 205,467 |
| Total | | 767,524 | 111,791 | 189,997 | 465,736 |
| % | | 100 | 14 | 25 | 61 |
| Other Companies | | | | | |
| Canadian ** | 4,267,177 | 907,117 | 1,343,766 | 212,362 | 3,618,166 |
| British | 432,149 | 96,879 | 48,707 | 21,177 | 459,144 |
| Foreign | 1,143,841 | 452,197 | 361,999 | 207,687 | 1,026,352 |
| Total | 5,843,167 | 1,456,193 | 1,754,472 | 441,226 | 5,103,662 |
| % | 100 | | 24 | 6 | 70 |
| All Companies | | | | | |
| Canadian ** | 4,267,177 | 1,374,093 | 1,453,508 | 357,426 | 3,830,336 |
| British | 432,149 | 148,209 | 47,713 | 25,402 | 507,243 |
| Foreign | 1,143,841 | 701,415 | 365,042 | 248,395 | 1,231,819 |
| Total | 5,843,167 | 2,223,717 | 1,866,263 | 631,223 | 5,569,398 |
| % | 100 | | 23 | 8 | 69 |
| Ontario Registered Companies*** (29 companies) | 400,419 | 76,043 | 172,601 | 87,950 | 251,911 |
| % | 100 | | 36 | 19 | 45 |
| Written in Ontario Only | 250,119 | NA | NA | NA | NA |

* Companies registered to transact Reinsurance Business Only

** Includes Canadian controlled, British controlled and foreign controlled Companies

*** Includes Business Written in Other Provinces

Source: Report of the Superintendent of Insurance for Canada Abstract of Statements of Property and Casualty Insurance Companies, 1981, pp. 71D.
For Ontario Figures: Companies' Statements

In 1981 about $5.5 billion of general insurance was underwritten by federally licensed primary insurers. $2.3 billion of reinsurance was assumed by these companies while $2.5 billion was ceded to reinsurers of which $631 million was placed with non-registered reinsurers outside the country. Estimates provided by the Brokers and Insurers Sub-committee indicate that placements of primary commercial and personal lines premiums outside Canada, in 1982, amounted to over $400 million, exclusive of the amount written by direct writing companies. These amounts show that a minimum of $1 billion of primary and reinsurance premiums is placed outside Canada annually.

In 1981, the assets held by the federally registered companies totalled $11,048 million. Capital surplus general and contingency reserves amounted to $3,032 million.

Table 9 : Property and Casualty Insurance Companies Assets, Capital Surplus General and Contingency Reserves, 1981

| | Total Assets | | Capital Surplus, General and Contingency Reserves |
|---|---|---|---|
| | $ Million | | |
| Canadian Companies: | | 7,005 | 1,493 |
| British Companies: | | | |
| -under control of Minister of Finance | 659 | | |
| -under control of Chief Agent | 148 | 807 | 213 |
| Foreign Companies: | | | |
| -under control of Minister of Finance | 2,481 | | |
| -under control of Chief Agent | 755 | 3,236 | 1,326 |
| Total | | 11,048 | 3,032 |

Source: Report of the Superintendent of Insurance for Canada. Abstract of Statements of Property and Casualty Insurance Companies, 1981, pp. 5D, 9D, 14D, 17D, 27D.

Table 10: Property and Casualty Insurance Companies: Ontario Licensed Companies, All Business*

| | 1981 | | 1982 |
|---|---|---|---|
| | | $'000 | |
| Direct Premiums Written: | 400,419 | | 493,722 |
| In Ontario Only | 250,119 | | 304,126 |
| Total Assets | 420,700 | | 443,423 |
| Capital, Earned Surplus and Reserves | 100,286 | | 119,606 |
| Reserves for Reinsurance Ceded to Unlicensed Reinsurers | 5,095 | | 4,978 |

* In 1981: 29 companies
In 1982: 28 companies

Source: Companies' Financial Statements

Table 11: Survey of 30 Foreign Controlled Property and Casualty Companies to Determine the Amount of Reinsurance on Business Written by the Canadian Operation Placed by Canadian Management and the Amount Placed With or Through the Head Office Located Outside Canada.

| | 1981 | | 1982 |
|---|---|---|---|
| | | $'000 | |
| Gross Direct Premiums Written | 3,237,153 | | 3,589,989 |
| Reinsurance Ceded by Canadian Management | 181,396 | | 201,031 |
| % of Direct Premiums | 5.6% | | 5.6% |
| Reinsurance Ceded to or through H.O. | 191,255 | | 259,165 |
| % of Direct Premiums | 5.9% | | 7.2% |

In the majority of cases, the percentage of insurance ceded by Canadian Management is approximately the same as that ceded through the Head Office.

## CHAPTER 3

## PRESENT PRACTICES OF DOING BUSINESS

### INTRODUCTION

The structure of the insurance industry is based upon the distribution of risk in such a way as to deploy sufficient capital resources to match the exposure to loss. The conventional marketing mechanism and sequence for the distribution of risk is shown in Figure 1.

In the majority of insurance transactions the insurance broker acts on behalf of the insured in negotiating with the insurer for the required policy contract. The exception is where the insured, or its captive insurance company, deals directly with a direct writing company, e.g. the Factory Mutual System. The fundamental goal of the insurer is to bring the policy contract and its services to the purchaser or insured. The essential functions carried out by the insurer, after the policy contract has been designed, include the underwriting, rating and reinsurance of the required coverage.

The reinsurance function may involve the primary insurer using the services of a reinsurance broker or intermediary to arrange for the "ceding", or giving of part of the risk, to another company or "reinsurer". Alternatively, the primary insurer may deal directly with a reinsurer.

An insurance company, primary or reinsurance, may in turn reinsure a risk which it has accepted from another insurer. Such secondary reinsurance is called a "retrocession" and the reinsurer of the reinsurer is referred to as a "retrocessionaire."

### The Role of the Broker

The broker represents the policy holder client and is the intermediary between the insurer and the insured. However, major brokers do not operate solely in a conventional intermediary capacity, nor do their relationships with insurer and insured lend themselves to an exact or legalistic delineation of functions.

The broker's principal functions are to serve the client or insured by offering advice and counsel on the handling of the problems of insurance and to negotiate the placing of risks. Such negotiations, while designed to obtain from the insurer the best terms, conditions

and rates for the insured, must be right and fair for both parties. In this sense the broker is responsible to both the underwriter and to the insured.

In many instances the skills, knowledge and trading connections required of major brokers in performing the brokerage role must be supplemented by other risk management, claims or captive management services.

Brokers are required to react to the changes in clients' needs. Technological developments have created changes in the demand for insurance through increased concentrations of values and new hazards. In addition to technology, the legal and political climate in many countries is emphasizing exposures which previously have been regarded as minimal or non-existent. These include the hazards of pollution, the growing emphasis on product liability, professional indemnity and political risk.

While client requirements are becoming more sophisticated, brokers are also responding to the widening geographical spread of national and multi-national companies and to the creation of captive insurance companies by large corporations. The management of such "captives" is a service provided by major brokers.

In reaction to these developments, the broker, together with insurers, has to devise new covers, provide new services, open up new markets, marshal new capacity and encourage and support the streamlining and improvement of the methods and procedures involved in the insurance industry.

## The Primary Insurer or Underwriter

Following negotiations with the broker acting on behalf of the client or insured, the primary insurer or underwriter selects risks on the basis of underwriting judgement. The insurer, as a professional risk bearer, transfers the risk of financial loss from the insured through a policy contract. Such "policies" serve as the basis for the rights and obligations of the insurer and insured.

Other than government insurers, primary insurers are divided broadly, on the basis of capital structure, into stock companies, mutual companies and other insurers. "Other" insurers include Lloyd's underwriters and underwriting syndicates on other insurance exchanges. There are two methods of product distribution used by primary insurers; direct to the insured, or through brokers. Although there are notable examples of insurers using the direct distribution method, most primary insurers deal through brokers.

Underwriting is the process of selecting, classifying and pricing the risks insured under policy contracts. This forms an essential element in any insurance operation for it is directly connected with the

adequacy of rates. While the selection of risks is ultimately done by the insurer, the broker is critical as a source of underwriting information.

Insurers, as well as brokers, are subject to the pressures of changes in insureds' requirements and must continue to respond promptly to the responsibilities placed on them by the increasing demands for adequate coverage, acceptably priced.

## The Direct Writer

In the area of property/casualty insurance for large risks, the principal example of direct writing companies, who deal directly with insureds rather than through brokers, is the Factory Mutual System. Other direct writing companies, primarily in the field of personal lines insurance, operate through salaried representatives or exclusive agents rather than brokers or independent agents, e.g. Liberty Mutual, State Farm and Allstate.

The four independent American mutual insurance companies operating under the Factory Mutual System are federally registered in Canada. They are organized together primarily to write highly protected and preferred commercial property risks with insurable values normally in excess of $5 million. While all are independent, they share the same engineering, inspection research and loss adjustment facilities.

## Reinsurance

Reinsurance is the transfer of insurance from one insurer to another. Its purpose is to spread risks, especially large ones, thus reducing the amount of possible loss by the original insurer to a manageable level in keeping with its capital and surplus. This increases the flexibility of an insurer and permits it to underwrite a continually expanding volume of business.

In a reinsurance transaction the insurer seeking reinsurance is known as the "ceding company", while the company assuming part of the risk is known as the "reinsurer". The reinsured portion of the risk is called the "cession". The foundation of reinsurance is based on full disclosure by the ceding company to the reinsurer as to the risk involved and the amount of insurance retained by the ceding company.

The reinsurance transaction is an agreement made between a ceding company and a reinsurer, whereby the ceding company agrees to cede, and the reinsurer agrees to assume, a certain fixed share of a risk on terms as set out in the agreement. The reinsurer is liable in respect of his share of any claim made by the insured, but his liability is to the insurer only. The insured may have an interest

indirectly in knowing that his insurer is supported by sound reinsurers, as this improves his security, even though he has no direct interest in the reinsurance contract.

There are two principal forms of reinsurance agreements -- "facultative", or specific, reinsurance and "treaty" or automatic, reinsurance.

Facultative reinsurance involves reinsurance of a specific risk, with a policy contract written on its own merit, after individual bargaining between the original insurer and the reinsurer. It was the first form of reinsurance and is still widely used as many risks fall outside the scope of automatic arrangements.

Treaty reinsurance involves the reinsuring of a proportionate amount of a designated class of risks under one agreement and includes future contracts as well as those in effect at the time of executing the agreement. This provides automatic protection for the original insurer. Treaties have overcome, for ceding companies, the disadvantages previously associated with the facultative method.

With the increasing demand for insurance, and the need for the primary insurers to secure obligatory cover that enables them to write business on a wide basis and on a surer footing, treaty reinsurance has, to a great extent, supplanted the older facultative method and has come into universal use in all classes of insurance business.

Retrocession is the reinsurance of reinsurance and occurs when the primary underwriting company cedes to a reinsurer who, in turn, wishes to give off a share of the cession and passes on part of the reinsurance to some other reinsurer. The reinsurer so accepting a retrocession is called the retrocessionaire. Retrocessions may be made facultatively by giving off each risk individually, or they may be done by treaty.

Reinsurance is truly an international business. When there is a hurricane in North America, for example, the French, the English, and the German markets all share in the loss. High inflation and the soaring costs of covering today's technologies necessitate the spread of risk around the world. A factory of 20 years ago presented only minimal risk when compared with its counterpart of today. Highly sophisticated computers and machinery can turn even a small plant into a big risk.

In addition to its international character, the reinsurance market is noted for its flexibility and the high degree of good faith required between contracting parties. The very factors that once benefitted the reinsurance market are now threatening to disrupt it. Easy access to world markets and the promise of attracting premiums that can be invested at high interest rates coupled with a lack of regulation have attracted so many participants that the reinsurance field has a surplus of capacity for normal risks. The resulting competition has, in turn, caused some companies to become undercapitalized. In addition to the resulting concern over the solvency of some reinsurers,

some countries in which certain reinsurers are domiciled have recently experienced serious international currency and debt management problems.

For a primary insurer these concerns create a relatively new problem of having to worry about the financial condition of the reinsurance company that stands behind it. Reinsurers themselves have become more careful about those with whom they place their retrocessions. These concerns on the part of all involved in the insurance process, from the insurer to the ultimate reinsurer, suggest a need for a facility that will provide the security required while maintaining the flexibility and capacity needed in the marketplace.

## The Reinsurance Broker or Intermediary

A primary insurance company seeking reinsurance protection for its needs may use the services of a reinsurance broker or intermediary. The extensive and often world-wide market contacts of the intermediary provide a high degree of flexibility in reinsurance markets and are particularly important when cover is required for very large or abnormal risks that may require mobilizing market capacity on an international scale. Intermediaries stimulate the quality of service, innovation and competition throughout the whole reinsurance marketplace.

In addition to responding to the reinsurance needs of the primary insurer, the intermediary can provide a reinsurance company with access to new markets and with assistance in placing its own retrocessions.

The extent to which any ceding company deals direct or employs an intermediary depends, in part, on individual needs and the terms being offered. Most reinsureds use a combination of brokerage and the direct markets.

## The Captive Insurer

A non-insurance corporation with large exposure to loss may form an insurance company of its own known as a "captive". Its basic role is risk management on behalf of its parent. It may retain a small portion of the risks involved and/or settle its own small claims and reinsure the major portion, often at Lloyd's or on the world market.

For many large industrial and commercial organizations, self retention of part of their insurable risks makes sound financial sense. When a corporation wishes to formalize risk retention and limit its liability over classes of insurance, the use of a wholly-owned insurance subsidiary or "captive" in conjunction with the conventional insurance

markets may provide the most cost-effective solution. Typically, captives are established in off-shore locations where operational restrictions are simplified.

Captives were originally formed because contributions to a funded retention program were not tax deductible as an expense, as opposed to premiums paid to an insurer. Subsequent rulings have greatly reduced such tax benefits.

Other features of a captive included accessibility to reinsurance markets, freedom to invest, ability to tailor coverage to the entity it insures and the opportunity provided to non-insurance firms to reduce their own insurance costs and, eventually, to diversify into insurance by writing third-party business.

Captives are also formed by certain industry associations to serve affinity groups. The advantages anticipated include tailored coverage at stable and competitive prices, reduced overhead and acquisition costs, accessibility to reinsurance markets and profit sharing.

At the end of 1981 there were 1,089 captive insurance companies in Bermuda alone. The captive premium volume in Bermuda may rival that of Lloyd's of London.

Captives have undergone a dramatic evolution in recent years. Virtually every multi-national corporation has considered this step and several hundred have adopted it. The explosive growth of captives in the last two decades was stimulated to some extent by excessive rigidity in rates and forms, the financial impact of rising interest rates and tax benefits.

## OVERCAPACITY AND CASH-FLOW UNDERWRITING

Insurance markets, products and operations have altered in recent years in response to high rates of interest, inflation and intensive competition.

Overcapacity, which presently exists in both the primary and reinsurance markets, results largely from cash-flow underwriting where greater interest is shown by the underwriter in the investment opportunities provided by the premium than in its adequacy to cover the risk involved. It is a dangerous technique when practised as standard operating procedure.

The international reinsurance market is experiencing difficulties because of an over-abundance of reinsurance companies that have been attracted into the business in the hopes of making investment profits to offset any underwriting losses. Some of these companies, while accepting Canadian risks, are not federally registered in Canada and hence there is no Canadian supervision or control over their ability

to respond to losses incurred. It is unlikely that any substantial amount of premiums ceded to these unregistered reinsurers would be invested in Canada.

Sir Peter Green, Chairman of Lloyd's London, spoke to the Annual Meeting of the American Association of Managing General Agents in Maui, Hawaii, in June 1983, and warned that cash-flow underwriting threatens the security of the insurance market. He outlined two disastrous scenarios that could take place unless the industry changes direction: "It is not impossible to imagine that a downturn in the money market could come one day and coincide with an expensive wind-storm, a blow-out in the North Sea or some similar catastrophe."

He went on to say: "Nor is that the only danger. The practice of selling insurance as a loss-leader has led, predictably, to an over-reliance on reinsurance where security has, for some time, been a cause for serious concern. So far failures have been comparatively rare but a fall in the value of investments could precipitate a flood and the domino theory could be seen to operate."

Overcapacity in insurance still survives, in part, because we have been spared from any very serious natural catastrophe for a decade. A dramatic decrease in interest rates and/or the occurrence of a major natural catastrophe will undoubtedly change the shape of the market. With security a major issue, primary insurers and reinsurers cannot cede their risks to those whose long-term solvency they doubt.

## CHANGES AND THEIR EFFECTS

Until a few years ago, the structure of the insurance industry and the patterns of ownership, control and function were reasonably clear-cut and well-defined. The majority of brokers, insurers of various types, reinsurance brokers, professional reinsurers and Lloyd's underwriters on the world insurance scene confined their activities to their own country and to their particular skills and discipline. New pressures for change have come to bear in recent years including:

(a) Nationalistic pressures to maintain a favourable balance of payments and to develop a strong domestic marketplace and financial centre.

(b) Multi-nationalism that has stimulated insurers and brokers to develop world-wide capability to serve multi-national clients.

(c) Regional markets which have resulted from the combined effects of nationalism and multi-nationalism, and which are receptive to offerings of inward business, predominately reinsurance.

(d) Absorption by financial conglomerates of insurance companies.

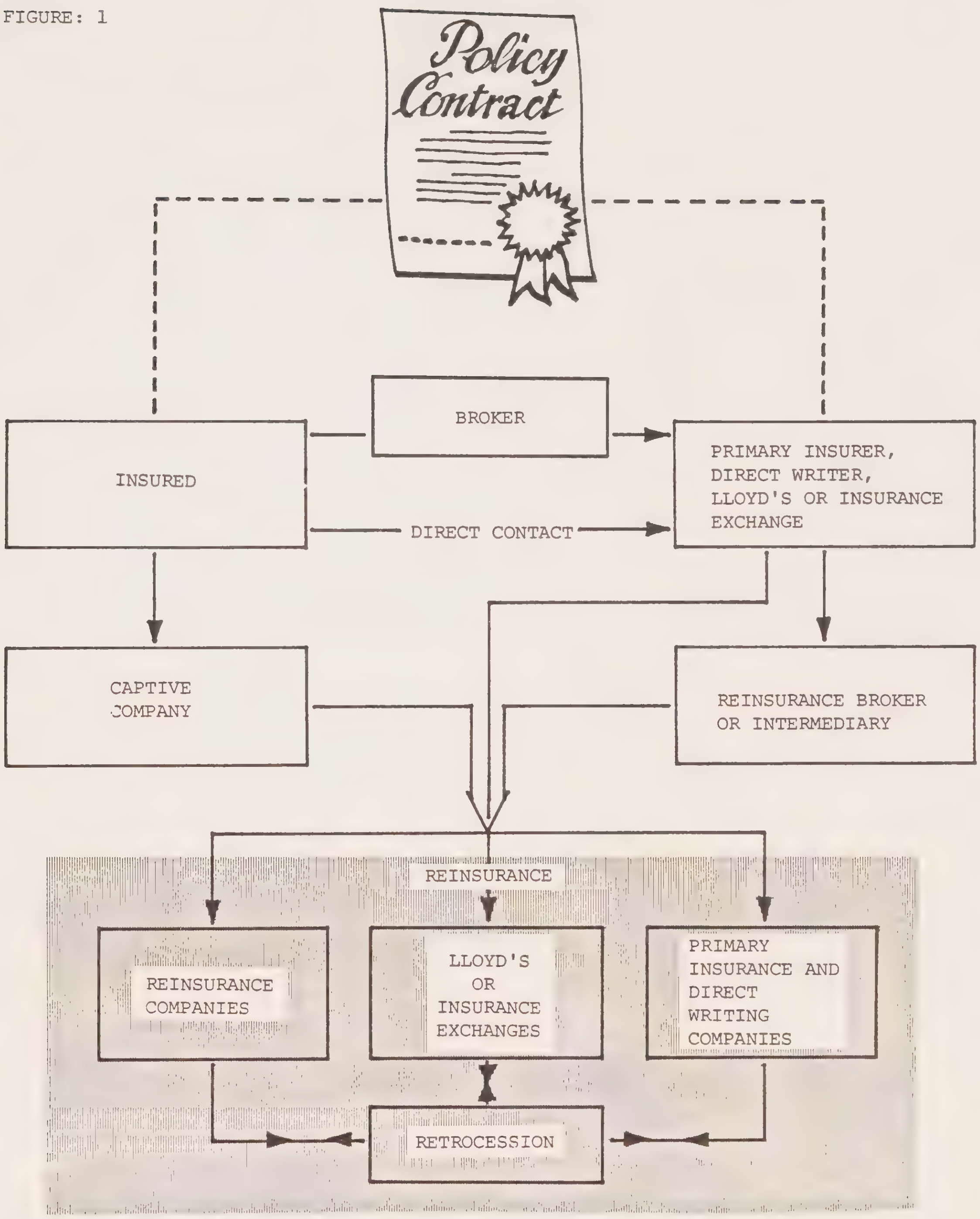
(e) Diversification into other activities within the insurance business.

(f) Transatlantic links through mergers or acquisitions by major brokers.

(g) Captive insurance company formation by major non-insurance corporations.

Despite these changes, the function of the insurance industry continues to be to arrange and deliver a program of insurance and reinsurance to clients that is financially secure and provides the capacity and scope of cover required, a claims and risk management service and a reasonable prospect of continuity. One of the options in response to the impact of pressures for change on the functions of the insurance industry is the establishment of an insurance exchange.

FIGURE: 1


Policy Contract
BROKER
INSURED
PRIMARY INSURER, DIRECT WRITER, LLOYD'S OR INSURANCE EXCHANGE
DIRECT CONTACT
CAPTIVE COMPANY
REINSURANCE BROKER OR INTERMEDIARY
REINSURANCE
REINSURANCE COMPANIES
LLOYD'S OR INSURANCE EXCHANGES
PRIMARY INSURANCE AND DIRECT WRITING COMPANIES
RETROCESSION

CHAPTER 4

# OVERVIEW OF FOUR INSURANCE EXCHANGES

## LLOYD'S OF LONDON

From its beginnings by Edward Lloyd in 1688, Lloyd's remained a coffee house to which anyone had access for the underwriting of marine risks until 1769. In that year a gambling scandal prompted serious-minded underwriters to find new premises. This lead to the election of a Committee in 1771 and to the payment of a subscription from which sprang the self-governing body to be incorporated in 1871 as the Society of Lloyd's.

It commenced writing non-marine and American risks in 1887 and, until 1980, when the New York Insurance Exchange was established, Lloyd's was the only Insurance Exchange available, world-wide, to insurers seeking reinsurance and to brokers, on behalf of clients, seeking coverage for large and difficult risks.

The Lloyd's market is principally divided into marine, non-marine, aviation and motor sections. There is complete freedom within these sections of the market to underwrite any type of risk relating to the section, other than a financial guarantee or surety type of transaction.

Lloyd's is not a company. It is a society of underwriters, over 21,000 individuals, all of whom accept insurance risks for their personal profit or loss and are liable to the full extent of their private fortunes to meet their underwriting commitments. Members are answerable to the Council of Lloyd's in matters other than underwriting.

While its fame and operations are world-wide today, its growth has been gradual and its control mechanisms have evolved as circumstances required over its 290 year history.

Following a serious underwriting syndicate failure in 1903, Members' Premiums Trust Funds were set up for all underwriters' premiums and in 1909 members of Lloyd's first submitted themselves to the Annual Audit.

In 1923 as a result of a fraud which deceived the Audit, Lloyd's policies began carrying a guarantee of liability supported by all members.

Beginning in 1924 all policies were issued through the Policy Signing Office, supported by a Central Fund contributed to by all Members in proportion to their premium income.

In 1939 Lloyd's set up the American Trust Funds which hold, in the United States, all American premiums.

In Canada, Lloyd's Trust Accounts were held within provincial jurisdictions until 1977 when Lloyd's became federally registered and Canadian trust accounts were consolidated and held federally.

In 1968 a Working Party was set up under Lord Cromer in response to the need for capacity, as an insufficient number of new members or "names" were coming forward. This resulted in the introduction of foreign and women members. Today, underwriting membership of Lloyd's is open to men and women of any nationality provided that they meet the stringent financial requirements of the Council of Lloyd's.

By the mid-1970's it had become clear that, in spite of a number of codifying Acts of Parliament, the unwritten rules of procedures, on which Lloyd's regulations were based, were inadequate for its needs and that radical reform was required.

In 1982 Lloyd's entered a new era with the Revised Lloyd's Act based on "a cybernetics principle of self-regulation". The two most important mandatory provisions are concerned with discipline and divestment.

Over the next four years the Act requires that brokers divest themselves of shareholding links with management underwriting agencies and establishes powers for setting effective rules regulating Members' activities. The Act also created a new Council and Committee -- the latter comprising working members of the Council with substantial delegated powers. Three members on the Council must come from outside the insurance industry.

The security controls have been strengthened by improving feed-back systems, by establishing an annual solvency test and by a Special Reserve Fund in addition to a Central Fund to which all members contribute by means of an annual levy. The positive function of these controls is to provide a climate of stability and order among members by clearly stating how they must conduct their business as opposed to what business they may underwrite or broke.

Lloyd's is subject to little government regulation. The Council of Lloyd's through its Committees, internally controls members, syndicates and their underwriting agents and brokers.

In 1983, 21,601 members of Lloyd's are grouped into more than 300 syndicates varying in size from a handful to several hundred names. The affairs of each syndicate are managed by an underwriting agent who is responsible for appointing a specialist underwriter for each class of business.

Representatives of 272 brokerage firms accredited to Lloyd's place business with underwriting agents representing syndicates at their boxes in the Room by presenting a "slip" describing the risk. The

underwriter commits his syndicate by initialling opposite the amount he agrees to subscribe.

The insurance broker is a key figure in the Lloyd's market. His prime duty is to negotiate the best available terms for his client. To this end he is free to place risks wherever he thinks fit, whether at Lloyd's, with the insurance companies or both. One of his most important roles in the market is to innovate new kinds of insurance. Brokers tend to develop as specialists in certain lines or categories of insurance. Increasingly, the broker tends to supply or arrange for other risk-related services, e.g. loss prevention and control, claims handling, etc.

There is a mystique about Lloyd's that has grown out of its traditions and rich history. Lloyd's is the major single facility involved in the flow of premium dollars from Canada and the United States to foreign insurance markets. Two-thirds of the almost $6 billion worth of business done annually by Lloyd's is reinsurance. Approximately fifty percent of Lloyd's total writings flow from the U.S. and Canadian markets. The original purpose of the American insurance exchanges was to stem this flow of premium dollars.

## NEW YORK INSURANCE EXCHANGE

Legislation providing for the formation of the New York Insurance Exchange (NYIE) was passed by the State Legislature in July, 1978. A 13-member committee chaired by the Superintendent of Insurance of the State of New York was established to draw up a constitution and by-laws for the proposed Exchange, the first since Edward Lloyd opened his London coffee house in 1688.

The NYIE was the first American attempt to forge a market facility capable of providing strong competition in the international insurance marketplace. The objects of the Exchange were to stem the flow of insurance dollars abroad, with $2 billion going to Lloyd's annually; to attract new capital to the insurance industry in the United States and to be an American version of Lloyd's of London. The New York Legislature enacted the Exchange's Constitution into law in September, 1979 and the trading floor opened for business on March 31, 1980.

The NYIE, as a marketplace or trading floor, is similar in concept to a stock or commodities exchange. Modeled on Lloyd's of London, it has both underwriting and broker members and is largely self-regulating. Syndicate membership is also open to outside investors with no insurance experience.

The NYIE is a facility through which member syndicates may underwrite insurance and reinsurance for the accounts of exchange brokers and a marketplace for the exchange broker to present large, complex or unusual risks to experienced syndicate underwriters. It provides a

market for reinsurance on all kinds of risks worldwide; direct insurance on risks outside the United States; direct New York business declined by the Free Trade Zone; and direct excess and surplus business on risks located in the U.S. other than New York State.

The NYIE differs from Lloyd's in two key respects. It allows both corporate and individual membership and holds underwriters responsible only for the capital subscribed, as opposed to Lloyd's where members are liable to the full extent of their private fortunes to meet their underwriting commitments. There are also differences in concept and operation.

An underwriting member of the NYIE is an underwriting syndicate, defined as "a person, firm, corporation or other entity authorized by the Board to insure or reinsure risks." Minimum capital of $3.55 million is required of a property/casualty underwriting syndicate with $6.55 million required of those also writing life and accident and health business. Each underwriting member is authorized to conduct an insurance business only on the floor of the NYIE. Underwriting members pay annual dues and assessments to the Exchange for services rendered each syndicate. Syndicates are managed by underwriting managers; some managing the affairs of more than one syndicate. They operate from booths or "boxes" on the trading floor of the Exchange.

Currently, the underwriting membership of the NYIE is made up almost exclusively of subsidiaries formed by existing insurance companies, both foreign and domestic. This has had the advantage of allowing the NYIE to establish itself as a viable entity as the initial risks have been undertaken primarily by those whose regular business it is to do so.

Broker members or associate brokers do all of the placing of business with underwriting members. To qualify as a broker member an applicant must be an insurance agent, insurance broker, or a reinsurance intermediary licensed in New York State who has been actively engaged in the insurance or reinsurance business for at least three years. An associate broker is not a member of the Exchange and is not permitted to vote. Although a broker member is permitted to place any eligible business directly with underwriting members, an associate broker is restricted to the placement of business with underwriting members solely for his own account. In all other instances an associate broker must place business through broker members.

Brokers circulate among the underwriters who are expert in the particular type of risk for which they must find insurance. The underwriter from whom they get the best quote takes a proportion of the risk for his or her underwriting syndicate. The broker may then approach other syndicates on the floor until the insurance has been written for the entire risk, or at least as much as can be placed in this market.

Broker members pay an initial fee of $10,000 and together with associate brokers and syndicates pay annual dues and assessments to

cover the expenses of the Exchange. Broker members are limited to less than 20 percent participation in the ownership of any syndicate and underwriting members of syndicates are, in turn, limited to less than 20 percent interest in any broker or associate broker membership.

When the New York Insurance Exchange opened for business in March, 1980, there was much speculation on its chances for survival and its ability to influence the insurance community. In the three years of its existence, despite overcapacity in the primary and reinsurance markets, inflationary pressures and continuing recession, the NYIE has shown steady growth as an insurance centre and an ability to provide access to those who wish to participate. From a beginning of 14 syndicates with an aggregate capital and surplus of some $60 million, the NYIE in 1983 has 36 syndicates represented by 21 underwriting managers with an aggregate capital and surplus of $159 million. In the same period broker membership has grown from 43 to 86.

The NYIE provides a Security Fund which covers all contracts written on the Exchange, whether direct or reinsurance, domestic or foreign. It can be utilized for the payments of unpaid contractual obligations of any insolvent underwriting syndicate. The two funds making up the Security Fund consist of a $500,000 deposit from the capital and surplus of each member syndicate plus the proceeds of a surcharge against all premiums written on the Exchange, currently set at 3/4 of one percent (0.75%). As of December 31, 1982 the total Security Fund for the protection of policy holders had reached $18 million.

The central processing facility of the NYIE receives and distributes all monies due on Exchange contracts whether premiums due to syndicates or loss payments to others. It also provides recordkeeping, data collection and statistical compilation of all insurance and reinsurance transactions written on the Exchange. As a result of utilizing cost-effective equipment and procedures, charges made by the Exchange to underwriting members represent only 1% of gross written premiums for 1982. As all transactions must be reported concurrently to the central processing facility, the Exchange staff maintains administrative control and provides current financial and statistical information on the business written on the Exchange to Members and Exchange management.

The market share of the NYIE has grown from $18.5 million in premiums in 1980 to $154.6 million in 1982. Virtually all of this has been reinsurance with direct insurance representing less than one percent of the total premiums written.

NYIE grew relatively slowly in its first two years as it surmounted various hurdles, faced legislative obstacles that prevented it from the direct writing of domestic risks and was handicapped by a market-place suffering from overcapacity. Its prospects for the future were greatly enhanced in 1983 when its charter was amended to allow writing of excess and surplus lines business from other States. This expanded authority will enable the NYIE to become a more balanced and complete market for its underwriting syndicates, as well as to intensify and expand broker support of the NYIE.

The U.S. reinsurance market has nearly tripled since 1973 and the size and growth potential in the facultative market alone will work to the advantage of the NYIE.

A study commissioned by the NYIE in 1981 indicated that by 1987 the NYIE is expected to write more than $850 million dollars in premiums. And, by 1991, if it is permitted to write direct insurance for risks from the 49 other States, the NYIE could be doing $5 billion of business annually and provide New York City with 20,000 jobs. Another informed estimate is that by 1985 it will attract back 15 to 20 percent of the premium income that United States currently sends abroad.

## THE ILLINOIS INSURANCE EXCHANGE

The Illinois Insurance Exchange (IIE) received its Certificate of Authority on November 20, 1981, having been signed into law in September, 1979. The Exchange opened for business in Chicago with three syndicates depositing total capital of $9 million. In 1982, its first year of operation, it wrote $2.5 million in premium through seven syndicates with a total capitalization of $18 million and it projects a premium volume of $10 million in 1983. Thirty-four brokers are operating from the IIE.

As with the New York Insurance Exchange, the IIE was established to capture at least a portion of the $4 billion of direct and reinsurance premiums exported annually from the United States, including $2 billion to Lloyd's. Unlike the NYIE, it does not purport to be national in scope or ambition but believes that as an insurance market it can retain, in Illinois, a substantial portion of the over $100 million of premiums on "hard-to-place" risks now exported to insurance companies not licensed in Illinois, thus creating additional jobs in the State and contributing to the continued growth of the State's economy.

The IIE claims to offer several advantages over the New York Insurance Exchange, including:

- Less restrictive capitalization for syndicates.
- Fewer limitations on the placement of direct insurance (such as the Free Trade Zone in New York).
- No restriction on broker ownership of syndicates.

The IIE hopes that this greater flexibility will result in more opportunity for the writing of direct insurance, particularly in specialty lines, as well as facultative and treaty reinsurance. While the majority of the 70 contracts or policies issued through the IIE in 1982 have been reinsurance, ten percent of its volume was in direct

insurance as opposed to less than one percent in the case of the NYIE. A direct risk with an annual premium in excess of $50,000, or a direct risk that cannot be placed with an admitted Illinois company, qualifies for placement on the IIE. It has the additional advantage of there being no Illinois premium tax on risks placed with the IIE.

Any licensed Illinois broker (resident or non-resident) or reinsurance intermediary may apply to become an IIE broker for an annual fee of $1,000. There is no limitation on broker participation in syndicate ownership. As in the case of the NYIE, the IIE is incorporated as a not-for-profit corporation. The IIE is funded primarily by annual assessments paid by syndicates and by fees from brokers.

Its security fund, the Immediate Access Security Association, holds deposits of 50% of a syndicate's capital for the protection of policy holders should an insuring syndicate be unable to meet its claim obligations. In March, 1983, IIE formed a Guarantee Fund for the payment of insurance claims against insolvent syndicates in the event the assets of such syndicates are insufficient to discharge their claims. The Guarantee Fund is funded by a premium surcharge. Should the premium surcharge be insufficient to satisfy the claims of the insolvent syndicate, the Guarantee Fund will contribute up to $500,000 per syndicate additional.

Its central processing facility is being conducted on a manual basis, but the IIE is fully committed to an automated approach as its transaction volume matures.

While the Illinois Insurance Exchange volume predictions have not materialized, it considers that its first year was successful and that it is in a position to take advantage of future opportunities.

## THE INSURANCE EXCHANGE OF THE AMERICAS

The Insurance Exchange of the Americas, Inc. (IEA) was incorporated in 1981 as a result of legislation adopted by the Florida State Legislature in 1979. This legislation led to the appointment of a Board of Governors of 14 who immediately commissioned a feasibility study which led in 1980 to the creation of the Insurance Exchange of the Americas. The IEA was created to assist in boosting Florida as a focal point for insurance and reinsurance and in developing Miami as an international financial centre.

The IEA is similar to the New York and Illinois Exchanges in that syndicates have limited liability through incorporation as opposed to the members of Lloyd's who have unlimited liabilities. Security is provided through a guarantee fund and all Exchange transactions are handled through a central accounting system.

The IEA claims to be modelled more closely after Lloyd's than the other U.S. insurance exchanges. It is argued that the nature and

history of Florida's insurance industry and its needs make it more conducive to an insurance exchange on the Lloyd's style of operation than New York or Chicago with their corporate dominated environments. Florida is by law an agency state and hence has no major broker presence nor are any large corporate insurance companies domiciled there.

Unlike the New York Insurance Exchange, the IEA, as with the Illinois Exchange, sees itself as serving the State rather than being national in scope. It has been stated that, while business will be sought nationally and internationally, the objective is to provide a focal point for the insurance industry in Florida and to aid the economy of the State.

The IEA was funded initially through a $450,000 line of credit from Miami banks and a contribution of $50,000 from the Greater Miami Chamber of Commerce. Its equity money of $500,000 was raised through the establishment of a Founders' category. This was comprised of those companies and individuals who would benefit from association with the IEA and included banks, attorneys, accountants and other professional groups, executive search and travel consultants, each of whom initially contributed $5,000 to support the IEA as a Founder. They have no vote on the Exchange.

Underwriting syndicates may be composed of corporate or individual investors and are capitalized at a minimum of $1.5 million for the writing of either property/casualty busines or life, accident and health. The minimum capitalization for all lines is $3 million. The initiation fee is $12,500 and underwriting members pay dues to meet the operating expenses of the Exchange. Broker members pay a $6,000 entrance fee and are assessed dues for their use of Exchange facilities.

An associate broker can place insurance only through a broker member and has no vote on the exchange.

An additional class of membership known as Subscribers consists of attorneys, accountants and other professional people providing ancilliary services to the Exchange. They are charged an initiation fee as well as expenses for the use of Exchange facilities. Subscribers may form Syndicate Agencies to provide office services, other than underwriting, for underwriting syndicates.

Early in 1983, the IEA reported forming 27 syndicates of which four were operational. 48 broker members were registered. The first policy (facultative reinsurance) was written in May, 1983.

The IEA expects to write about $25 million in gross premiums during 1983 -- 35 to 40% in the Caribbean and Latin America, 40 to 45% in the U.S. and about 15% elsewhere.

The IEA is authorized to place all classes of reinsurance, direct insurance of all classes of risks located outside of the United States, surplus lines insurance as defined by the Florida Insurance Code and marine, aviation and transportation insurance.

CHAPTER 5

# THE POTENTIAL OF A CANADIAN INSURANCE EXCHANGE

## EXCHANGE-POTENTIAL ROLE AND CONTRIBUTION

An Insurance Exchange, based in Toronto, would serve and be accessible to the entire Canadian insurance community. It would provide a centralized market facility or focal point for the industry. As with Lloyd's and the three American Exchanges, it would be an association of brokers and underwriting syndicates, creating a pool of expertise and an intelligence network to facilitate the placement of all types of risks, including those that are large, complex and unusual. Brokers representing insurance buyers, would seek the best price and coverage for their clients' risks from the underwriting syndicates in an open market environment.

An Insurance Exchange would be conducive to innovative responses to the needs of insurance buyers. Such an Insurance Exchange, by providing capacity with sound financial backing, would stimulate the growth of Canadian insurance underwriting into additional geographic and product areas.

An Insurance Exchange, through the use of cost-effective equipment and procedures, would keep costs at a minimum level commensurate with prompt and efficient service, thus benefitting the public (insureds), underwriters (insurers) and brokers.

All of the Exchange members would benefit from the economies and convenience resulting from a centralized accounting, payment and documentation system. Such a facility would receive and distribute all monies due on Exchange contracts, whether premiums due to the syndicates or loss payments to others. It would provide record keeping, data collection and statistical computation of all insurance and reinsurance transactions written on the Exchange.

The Advisory Committee envisages the Insurance Exchange as a self-regulating, centralized marketplace governed by a Board of Directors, elected by its members, with governmental endorsement and support. The standards of conduct set by the Insurance Exchange, including the prompt settlements of claims and the sound backing for clients' policies through a guarantee fund, would provide a high degree of comfort to insureds.

## BENEFITS TO THE INSURANCE COMMUNITY

### Underwriters

The syndicate principle enables all forms of investors to participate, whether they be insurance companies, other corporate investors or individuals. For the latter it provides the attraction of close personal involvement and interest.

On an Insurance Exchange, underwriters would efficiently spread risk, share expertise and reduce policy processing and other administrative costs. For the insurance company, the Exchange offers "visible" participation in specialty line risk taking by using the specific skills of its own underwriters as well as trading on the expertise of other underwriters when taking a "following" position. Unlike an insurance pool, the syndicates would maintain control over the underwriting of particular risks. An Exchange would also provide an opportunity for insurers within syndicates to take a percentage net retention in risks that they might not ordinarily be inclined to accept completely.

Private individuals, as syndicate subscribers, could participate in the underwriting of risks as do the present Canadian "names" in Lloyd's but without the unlimited liability required by Lloyd's. If tax rulings granted such subscribers parity with Canadian "names" in Lloyd's, it would have a favourable impact on the Exchange[3] through a new source of capital for the Canadian insurance industry.

For foreign insurers the Exchange could become a prudent first step in entering the Canadian market where established outlets are not in place. Bringing a foreign-owned syndicate within the governing of the Exchange and its guarantee fund would be additional protection for potential Canadian policy holders.

### Captives

Large corporations form offshore captive insurance companies to reduce insurance costs; to secure needed coverage; to avoid taxes on self-insurance funds under certain conditions, and to write third party business. With the tax benefits originally contemplated being reduced by subsequent tax rulings, captives are placing greater emphasis on their basic role of risk management. A captive insurance company forming a syndicate on the Exchange to underwrite current company insurance programs, as well as programs from non-affiliated sources, would have a readily accessible, low-cost distribution system and be less vulnerable to insolvency problems when ceding reinsurance.

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3 See Chapter 8: Tax and Legal p. 60

## Brokers

For brokers, an Insurance Exchange would provide a centralized, highly secure marketplace where coverage can be placed quickly, easily, efficiently and at competitive prices. By shopping under one Canadian roof for their insurance and reinsurance needs, brokers would be spared the high costs and time constraints involved in placing business in foreign markets. Most importantly, any reduction in costs at the underwriting and brokerage levels achieved through the use of Exchange facilities should result in lower premiums for the insuring public.

## AVAILABILITY OF POTENTIAL MARKET

To forecast the market potential for an Insurance Exchange, it must be assumed that there are no restraining or confining elements by way of legislation, or other constraints, that would seriously affect the availability of the market. In the case of Lloyd's, the only underwriting restriction is financial guarantees or surety type transactions. The New York Insurance Exchange, on the other hand, can write only reinsurance; direct insurance on alien risks; risks rejected by the Free Trade Zone and, most recently, surplus lines risks outside New York State. The Illinois Insurance Exchange has greater freedom in that it can write direct U.S. business (over $50,000 annual premium or if declined by the licensed Illinois market) and reinsurance on all classes except life insurance. The Insurance Exchange of the Americas in Florida can write direct insurance on alien risks, Florida surplus lines insurance and reinsurance of all kinds and origins.[4]

To ensure its viability and to realize its maximum potential as a competitive force in domestic and international insurance, an Insurance Exchange has to provide a market flexible enough to accept and write insurance and reinsurance on risks from both within and outside Canada. It should have the ability to place direct business on all domestic and international risks of whatever kind, as well as reinsurance of all kinds.

## POTENTIAL SOURCES

### Reinsurance

In Chapter 3 - "Present Practices of Doing Business" - reference was made to the two principal forms of reinsurance agreements - facultative (one policy reinsurance) and treaty (more than one policy).[5]

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[4] See Appendix "A" for details

[5] p. 22

As has been the case with the American Exchanges, a Canadian Insurance Exchange would most likely first attract reinsurance in the form of facultative, rather than treaty, cover because of the convenience of a one-stop shopping place for such individual transactions. There should be no premium threshold for the underwriting or reinsurance.

While an Insurance Exchange would first attract a greater preponderance of facultative covers, it is felt that it would be successful in writing a significant volume of catastrophe treaty covers. The object of such treaties is to protect the reinsured against unexpectedly large losses due to the occurrence of some event causing an accumulation of losses from more than one insured risk. Much of the capacity for such risks is presently found outside of Canada.

While personal lines represent approximately two thirds of the Canadian general insurance market, relatively little reinsurance would be available to an Insurance Exchange other than catastrophe treaty covers now being ceded abroad by private sector and government owned insurers.

The Federal Government is considering legislation restricting the ceding of reinsurance to unregistered companies outside of Canada. Such action could encourage these companies to join the Insurance Exchange. Also, as this legislation would affect those Canadian companies heavily dependent upon such reinsurance they may elect to employ their capital in underwriting through a syndicate on the Insurance Exchange.

It is believed that non-Canadian reinsurance could be attracted to a Canadian Insurance Exchange particularly if the Exchange were recognized as a licensed market throughout the U.S.A. Such recognition would have a positive impact on the quality of the business seen coming to the Exchange and therefore enhance its appeal to potential underwriters.

## Primary or Direct Insurance

Specialty Risk Insurance - It is felt that, in regard to primary or direct insurance, an Insurance Exchange would compete most effectively through its response to the needs of the specialty lines insurance market, including unique and unusual "hard-to-place" risks, which typically have been insured through Lloyd's. While currently most specialty risk insurance is placed outside of Canada for competitive rather than capacity reasons, there is a strong feeling that Canada should have and would support a marketplace for such risks.

Commercial Lines - Based on the fact that the high cost of doing business outside of Canada and the time constraints involved are major items affecting all brokers, there exists an opportunity for an Insurance Exchange to compete for the estimated $354 million of commercial premiums being placed by Canadian brokers and agents outside Canada annually.

An Insurance Exchange could hope to attract some foreign risks particularly with the strong support of those Canadian brokerage firms that operate internationally.

Personal Lines - Approximately $58 million of personal lines premium is being placed by brokers and agents through non-Canadian contract facilities. Many of these contracts are through Lloyd's with the domestic broker having the underwriters "pen" to permit the prompt issuing of policies. A similar method would be the only practical way of ensuring a volume of direct personal lines business through an Insurance Exchange.

Even though the potential for personal lines, based on current practice, is not as great as that for commercial lines, there may be a unique opportunity to capture a large proportion of the personal lines premium that currently flows directly out of Canada.

## FACTORS INFLUENCING MARKET AVAILABILITY

The greatest single factor that could influence the availability and size of the potential market for an Insurance Exchange would be the extent of the commitment to the Exchange concept by the Canadian insurance industry - the insurers who would be the basis of the underwriting syndicates and the major brokers and reinsurance intermediaries who would bring the business to the Exchange.

Specifically, the success of the Insurance Exchange in developing a sufficient share of the property/casualty insurance market to make it commercially viable would depend on the following:

- A sufficient number of syndicates with the necessary high capacity and flexibility to underwrite the risks involved.

- A strong security or guarantee fund that would protect insurance against the insolvency of any member of the Exchange.

- The receptivity of underwriting syndicates and brokers to the needs of insureds, and their initiative in supporting these needs.

- The ability to attract underwriters and staff with the expertise, experience and authority necessary to establish and maintain the credibility of the Exchange.

- The provision by underwriters and brokers of experienced and knowledgeable personnel to the Exchange.

- Efficient and cost-effective central processing facilities.

- Prompt claims settlements.

- Potential profit for the investor.

Chapter 6 covers the reservations, or more appropriately the cautions, expressed by both underwriters and brokers relating to the achievement of these objectives. They were concerned particularly with timing and the effect of an Insurance Exchange on the present flow of business. All agreed that such concerns would be overcome as confidence in the Insurance Exchange developed and that none represented serious or continuing impediments to a successful operation.

## CHAPTER 6

## REACTION OF INSURANCE AND INVESTMENT COMMUNITIES

### KEY ELEMENTS OF AN INSURANCE EXCHANGE

The two basic components of an Insurance Exchange are: AVAILABLE PREMIUM (customers) and AVAILABLE CAPITAL (insuring capacity).

Currently and traditionally, a large proportion of the insurance and reinsurance premiums potentially available to the Canadian insurance industry is attracted to foreign markets. The reduction of this outflow of premium dollars, and the encouragement of outside capital to participate on the Insurance Exchange, requires the combining of skillful and credible underwriting with the security provided by a guarantee fund.

The provision of underwriting capacity, and its supportive security, requires investment capital that is now being directed into other domestic and foreign insurance and non-insurance areas. The redirection of such capital will be encouraged by the potential for profit within a self-regulatory environment.

Figure 2 (p. 51) illustrates in a 3-stage schematic form, the conditions under which these two key components of Available Premium and Available Capital can be brought together in an Insurance Exchange.

### TIMING AND CAPACITY

Currently, there is an overcapacity in the primary and reinsurance markets for the conventional lines of business and underwriters do not forsee a significant shortage developing in this area of risk. However, it has been suggested that, to a degree, overcapacity is a myth, with so many risks either under-valued or under-insured. With economic growth and technological progress creating new and large projects, a ready and innovative market is required.

Certainly the upward spiral of values, particularly in high technology industries and energy-intensive products, will place increasing demands on the insurance markets in the years ahead and an Insurance Exchange would be a logical response.

The New York Insurance Exchange was born at a time when the capacity was not fully required and argued that the best time to start was

when a capacity trough was starting to bottom out to enable it to spend its first year or two learning to crawl before it walked. It is felt that the timing is appropriate for the planning and structuring of a Canadian Insurance Exchange that will lead to a cautious start and have such an Exchange ready when economic conditions tighten the market. An Insurance Exchange with fresh sources of capital would build a Canadian insurance capacity.

## POTENTIAL VOLUME

The volume of business required to ensure the viability of an Insurance Exchange as a commercial venture will be brought to the Exchange by brokers and reinsurance intermediaries seeking the most favourable market for their clients' needs. Their support will depend obviously on the ability of the syndicates represented on the Exchange to engage underwriting members and supporting staff with the requisite expertise, experience and authority to act. Their receptivity to the risks being offered, and their initiative in meeting the requirements of the insurance public through the brokers, will be the bases of establishing the credibility of the Insurance Exchange as a potent force on the Canadian underwriting scene.

### Reinsurance

In the reinsurance field, the long-standing relationships between primary insurers and reinsurers will continue to be tested by the competitive environment of an Insurance Exchange. Broking and underwriting skills will influence the directing of Canadian cessions to an Insurance Exchange.

In 1981 $2.5 billion was ceded by Canadian insurance underwriting companies to reinsurers. Of this total $631 million or 25 percent (Table 8) was placed with non-registered reinsurers. Some of these are marginal reinsurers, who entered the business when demand for reinsurance was heavy in the 1970's. The barriers to entry were minimal and the profit potential was high. Now, as interest rates fall and investment income responds more rapidly than premiums, the effects of cash-flow underwriting are taking their toll.

Quantification of the potential volume for reinsurance on a Canadian Insurance Exchange from the various sources, including the effect of Federal legislation on the business available to the domestic reinsurance market, is virtually impossible. As the New York Insurance Exchange has been almost exclusively a reinsurance marketplace, some indication of market availability may be gained by reviewing its experience during its three years of operation and its projections for the future. The projections are based upon a report prepared by the Diebold Group in April 1981 for the NYIE titled, "An Analysis of the New York Insurance Exchange's Economic Impact."

Table 12 shows the actual treaty and facultative reinsurance, direct insurance, total premium volume and percentage of market penetration for the New York Insurance Exchange during its three years of operation up to and including 1982, together with its projected market penetration in 1987 and 1991.

In 1982, NYIE's total premium volume of $156 million moderately exceeced the projection for the year. Of this total, facultative reinsurance accounted for 32 percent and treaty reinsurance premium volume increased to 67 percent of the total. Direct business continued to be minimal at less than 1 percent. Management of the NYIE is confident that it will achieve its projection of $1 billion premium volume in 1987. As indicated in Table 12 this would represent a 2.7 percent penetration of the market available to the NYIE for reinsurance, both treaty and facultative, and a 3.6 percent projected penetration of its total available market.

In its projections, the Diebold Report assumed enactment in mid-1981 of legislation permitting the NYIE to accept direct excess and surplus insurance on domestic risks outside the State of New York. This legislation was not enacted until mid-1982. The report considers that the New York Insurance Exchange's total available market consists of three segments: facultative reinsurance, treaty reinsurance, and direct insurance (excess and surplus lines only). Forecasts of available market exclude the international market. For purposes of the study, the available insurance market was assumed to grow 14.5 percent annually between 1981 and 1983, and 16.5 percent annually between 1983 and 1991 (Canada's market growth for property/casualty companies was 13.27 percent in 1982; 14.38 percent in 1981 and 8.61 percent in 1980). The reinsurance sector between 1983 and 1991 was assumed to grow annually 15.5 percent for treaty and 22.5 percent for facultative reinsurance. All forecasts were current year dollars with 10 percent annual inflation assumed.

In an effort to quantify, on a conservative basis, the volume of reinsurance that might be anticipated on an Insurance Exchange, the available insurance market in Canada is assumed to grow by 9 percent annually with the percentage of reinsurance ceded remaining at the 1981 figure of 39.5 percent.

Table 13, "Projected Canadian Insurance Exchange Market Penetration and Percent of Available Market" presents assumptions of available insurance market penetration and projections of direct insurance now placed outside Canada. It assumed that in the initial year of 1985 the Insurance Exchange can expect to receive 0.2 percent of the available market, or premiums worth $20 million of which $15 million would be reinsurance. This compares favourably with the premium volume on the NYIE of $26 million in its initial year. By 1987, it is believed that the Insurance Exchange will capture at least one percent of the available market, or premiums totalling $118 million of which

$98 million would be represented by treaty and facultative reinsurance. The Insurance Exchange's 1992 market penetration and premium volume is estimated to be approximately 3.0 percent or $540 million.

As stated, Table 13 is based upon the experience and projections of the NYIE as a reasonable basis for assumptions regarding reinsurance market growth and penetration but not for projections on potential volume of primary or direct insurance premiums, as it reflects the restrictions that limit the underwriting of direct business by the NYIE.

## Primary or Direct Insurance

It is assumed that a Canadian Insurance Exchange would be an acceptable and recognized marketplace for all domestic and foreign primary or direct business. Consideration may be given to a reasonable premium floor on domestic risks.

The Committee reviewed the present practices of brokers placing business outside of Canada, and took a survey of all national brokers to arrive at a forecast of the market potential for primary or direct business.

In addition it considered the advantages of an Insurance Exchange as a marketplace for all Canadian brokers and agents, particularly with regard to risks of a nature or size that would make underwriting difficult through present markets.

It also undertook to determine the reaction to the establishment of an Insurance Exchange by major insureds, including those having captive insurance companies.

There was consensus that, while an Insurance Exchange would be supported by brokers, there was qualified support by major insurers. On the other hand, risk managers of large corporations, including those involved in captive insurance company operations, continue to show great interest in the deliberations of the Advisory Committee. The Chairman has been invited to address meetings of Chapters of their Society (Risk and Insurance Management Society) in Toronto, Ottawa and Montreal, where, in September, 1983, he was the opening speaker at the Canadian Risk Management Conference.

It is estimated that six national brokers place approximately 20 percent of the total available Canadian market, and that this represents 58 percent of the commercial, or non-personal lines, business in Canada. Most importantly, from an Insurance Exchange point of view, these national brokers place the majority of the large and highly specialized risks.

Impetus for the success realized by the NYIE, in a difficult marketplace, resulted from the support of the major national and international brokers and reinsurance intermediaries. The NYIE was fortunate,

as the original American exchange, in having the support of these large international brokers who were firmly committed to its success and who directed business to the NYIE which could have been placed in any one of a number of markets at comparable pricing. Correspondingly, active support from these brokers would be critical to the growth of an Insurance Exchange in Canada. A failure to recognize the importance of the role of the international broker in the success of the Insurance Exchange would seriously inhibit the growth of the Exchange and prevent it from realizing its market penetration projections.

The projections of primary or direct insurance volume, as in the case of reinsurance, are based upon an annual 9 percent growth rate in the Canadian insurance market. It was considered that the greatest opportunity for penetration of the direct insurance market would come from risks now being placed outside of Canada by Canadian brokers and agents. These placements were estimated to represent $412 million in premium income in 1982.

Conclusions respecting the market potential have been made on a general and long-term basis, with the percentage penetration by a Canadian Insurance Exchange of the present bulk of business placed outside Canada growing on the basis of 1 percent annually.

Based on the total estimated premiums for placements outside Canada in 1982, these projections indicate a premium volume of direct insurance from business formerly placed outside Canada of $5 million in the initial year of an Insurance Exchange. This would grow to $20 million in 1987 and to approximately $78 million in 1992.

TABLE 12: NYIE MARKET PENETRATION AND PERCENTAGE OF AVAILABLE MARKET TO NYIE

U.S. $ Million

| | 1980 | 1981 | | 1982 | | Projected 1987** | | Projected 1991** | |
|---|---|---|---|---|---|---|---|---|---|
| | Volume* | Volume | % of AM | Volume | % of AM | Volume | % of AM | Volume | % of AM |
| NYIE $ Premiums | 26 | 72 | 0.5 | 156 | 0.9 | 1,000 | 3.6 | 5,000 | 7.0 |
| Reinsurance: | | | | | | | | | |
| Treaty | 14 | 37) | 0.6 | 105) | 1.1 | 473) | 2.7 | 2,260) | 6.3 |
| Facultative | 12 | 35) | | 50) | | 314) | | 1,400) | |
| Direct Insurance | 0.5 | 0.7 | | 1.3 | | 213 | 3.2 | 1,340 | 13.0 |
| Total Available Market | | 15,400 | | 17,600 | | 36,300 | | 68,300 | |
| Reinsurance: | | | | | | | | | |
| Treaty | | 9,500 | | 10,700 | | 20,800 | | 38,000 | |
| Facultative | | 2,500 | | 3,200 | | 8,900 | | 20,000 | |
| Direct Insurance | | 3,400 | | 3,700 | | 6,600 | | 10,300 | |

* 9 months annualized

** Projections are based on an annual market growth of 14.5% between 1981 and 1983, and 16.5% between 1983 and 1991, and 10% annual inflation rate.

Source: An Analysis of the New York Insurance Exchange's Economic Impact. Prepared by the Diebold Group for the New York Insurance Exchange, 1981.

TABLE 13: PROJECTED CANADIAN INSURANCE EXCHANGE MARKET PENETRATION AND PERCENT OF AVAILABLE MARKET* (AM)

$ Million

| | 1981 | 1982 | Projected 1985 | | Projected 1986 | | Projected 1987** | | Projected 1992** | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Volume | Volume | Volume | % of AM | Volume | % of AM | Volume | % of AM | Volume | % of AM |
| Insurance Exchange $ Premiums | | | 20 | 0.2 | 65 | 0.6 | 118 | 1.0 | 540 | 3.0 |
| Reinsurance | | | 15 | 0.4 | 53 | 1.2 | 98 | 2.1 | 462 | 6.5 |
| Direct Insurance formerly placed outside Canada | | | 5 | 1.0 | 12 | 2.0 | 20 | 3.0 | 78 | 8.0 |
| Total Available Market | 7,000 | | 9,900 | | 10,800 | | 11,800 | | 18,000 | |
| Reinsurance | 2,800 | | 3,900 | | 4,300 | | 4,700 | | 7,100 | |
| Direct Insurance | 4,200 | | 6,000 | | 6,500 | | 7,100 | | 10,900 | |
| - formerly placed outside Canada | | 412 | 533 | | 581 | | 633 | | 974 | |

* Total Canadian market: excluding Provincial Government insurance operations.

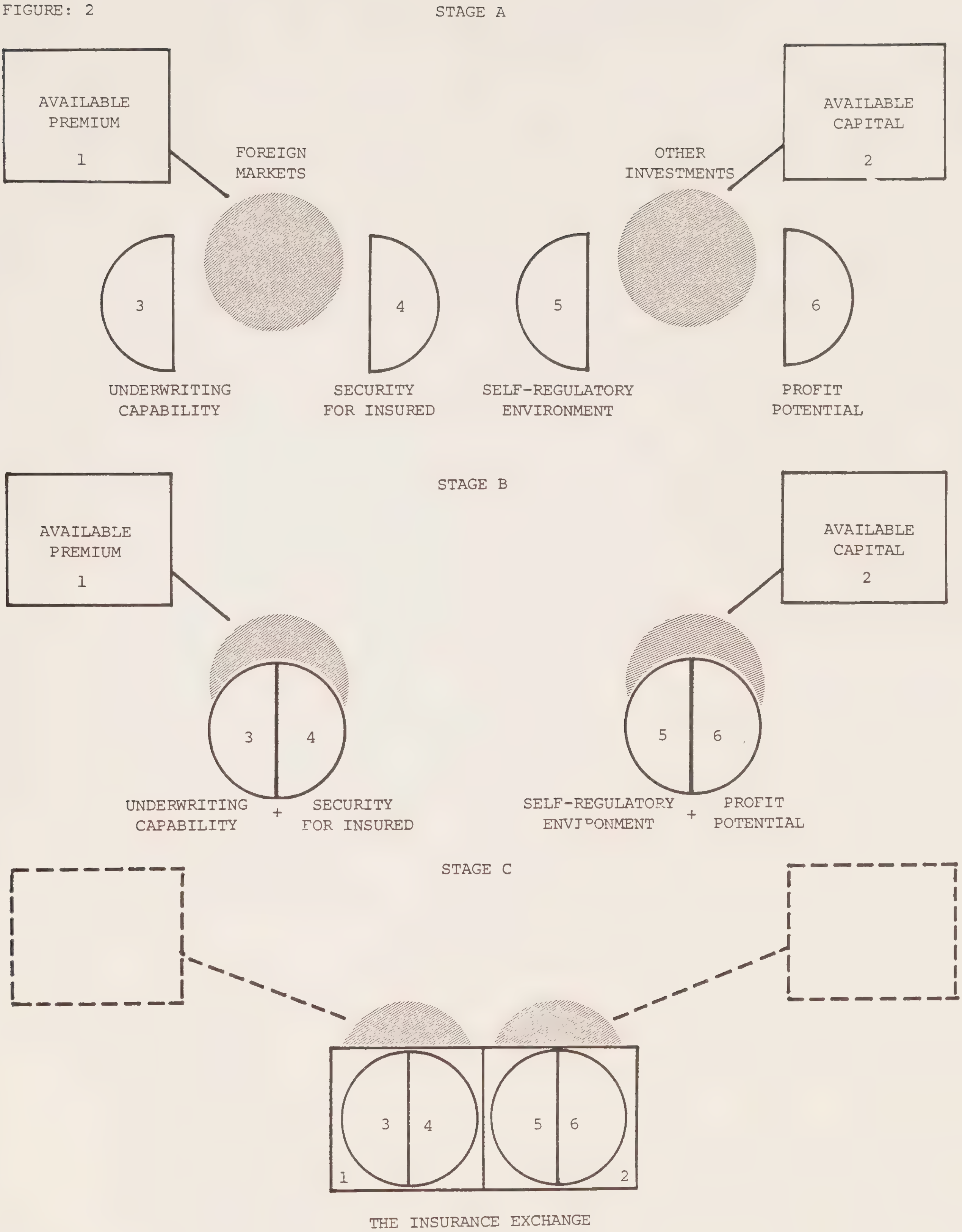
** Projections are based on an annual growth of 9%.

POTENTIAL FOR GROWTH

It should be appreciated that an Insurance Exchange will require a considerable start-up time and it may take several years before it becomes a real factor in the Canadian insurance industry. Such an institution should grow slowly at first as it gains experience and, above all, earns a reputation for its expertise, efficiency and security. This is considered to be advantageous because initially the main business of the Exchange would likely be reinsurance, and throughout the world today there is an over-abundance of reinsurance capacity. It is axiomatic that further capital pledged to this area at a time of overcapacity would only increase the over-supply and act to depress rates, thus attracting the less desirable risks and opening the door to the very real prospect of underwriting losses.

On the other hand the insurance industry is cyclical in nature and will ultimately enter another period when the current world capacity will be utterly insufficient to meet the needs of the balance of this century or even begin to meet those of the next. When such a period arrives, one cannot suddenly put together a "Canadian Insurance Exchange". It has to be done when the opportunity is present to draw upon the collective wisdom of the most informed members of the insurance community with their common interests and concerns. Thanks to the initiative of the Government of Ontario and the response of the insurance industry, an opportunity has been seized that, with patience and forebearance, can lead to the creation of a successful Insurance Exchange.

FIGURE: 2


STAGE A
AVAILABLE PREMIUM
1
FOREIGN MARKETS
OTHER INVESTMENTS
AVAILABLE CAPITAL
2
3
4
5
6
UNDERWRITING CAPABILITY
SECURITY FOR INSURED
SELF-REGULATORY ENVIRONMENT
PROFIT POTENTIAL
STAGE B
AVAILABLE PREMIUM
1
AVAILABLE CAPITAL
2
3
4
5
6
UNDERWRITING CAPABILITY
+
SECURITY FOR INSURED
SELF-REGULATORY ENVIRONMENT
+
PROFIT POTENTIAL
STAGE C
3
4
5
6
1
2
THE INSURANCE EXCHANGE

# CHAPTER 7

# CAPITAL AND FINANCIAL REQUIREMENTS

The task of projecting financial and capital requirements for the establishment and operation of an insurance exchange was divided into two major assignments:

1. Qualifying the financial needs and examining their implications.

2. Quantifying the costs involved.

It was recognized that compiling the list of financial requirements would be the easier of the two assignments. A projection of dollar estimates is so contingent upon a number of inter-related factors with attached provisos, such as estimated activity level, that any forecasts at the exploratory stage of the study would be difficult to ascertain.

An Insurance Exchange, as an integral part of the Province's financial structure, will be affected by the overall economic and financial climate as it will influence the extent to which capital will be attracted to the Exchange.

For the prospective Exchange member, the cost of conducting business on the Exchange and the profit potential will be the key factors in arriving at a decision to join. It is obvious that the capital and financial requirements, including start-up costs, bear a relationship to the Exchange's projected rates of growth in membership and activity.

In analyzing the capital and financial considerations relative to a proposed Insurance Exchange, it is important to distinguish between two main components:

- the Insurance Exchange itself and

- the participating members.

## THE INSURANCE EXCHANGE

The Insurance Exchange, as a separate and self-regulating entity, will incur both start-up and administrative costs, and will require the funding of a security or guarantee fund to protect insureds against the insolvency of any member of the Exchange.

The start-up and administrative costs could be financed by government, participating members or shared by both parties.

(a) Start-Up Costs

- Legal
- Accounting
- Organization

(b) Administrative Costs

- Salaries
- Accommodation
- Central Processing Facilities
- Accounting and Audit

The amount of capital required to cover start-up and on-going operational and administrative costs will depend upon the extent of participation by Exchange members and the level of service provided. It will take time to develop the volume of business necessary to achieve a break-even point. This again emphasizes the importance of exerting every effort to enlist sufficient members and encourage the level of activity necessary to make it a viable operation at an early stage.

It will be necessary to survey the insurance and investment communities in depth to determine conditions under which they would be prepared to participate and their degree of commitment to the Exchange.

(c) Security or Guarantee Fund

For the protection of insureds against the insolvency of any member of the Exchange it is necessary to create and administer a security or guarantee fund. This could be provided by segregating a portion of the initial capitalization of each syndicate and, on an on-going basis, funding through a charge calculated as a percentage of premium income.

PARTICIPATING MEMBERS

Underwriting Syndicates

(a) Capital requirements:

The underwriting capacity of the Exchange is directly related to the capitalization of the syndicates. The security of all insureds is also an important consideration, particularly regarding the form or liquidity of the contributed capital, and the extent to which a portion of the initial capital is committed to a security or guarantee fund.

The minimum capitalization required for syndicate membership and the form and conditions under which it is subscribed, need to be such as to encourage membership while ensuring the maximum security for all insureds. The other insurance exchanges give some guidance in this respect. [6]

(b) Cost of syndicate operations:

- Initiation fee
- Annual assessment based on Exchange overhead costs
- Rent
- Underwriting management
- Staff salaries
- General administrative expenses

(c) Cost of compliance with Exchange requirements:

- Contribution to guarantee fund
- Bonding
- Reporting requirements

Broker Members

- Initiation fee
- Annual assessment fee
- Staff salaries
- Rent
- Administrative expenses

One of the primary objectives of an insurance exchange would be to attract new capital to the insurance industry in Canada, making it possible for its members to insure certain types of risks which have in the past been placed outside Canada. It may be assumed that initially most syndicates would be composed of existing insurance companies which would mean a redirection of capital now employed within the insurance industry. The Exchange should be structured to encourage syndicate ownership by other investors, both domestic and foreign (about one-third of the syndicates now operating on the New York Insurance Exchange represent foreign capital).

Investment opportunities presented by a soundly structured Exchange, strongly supported by the Canadian insurance industry, will have the potential of attracting new capital to the industry from a wide range of investors including individuals and non-insurance corporations, captive insurers and foreign insurance companies.

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[6] See Appendix "A" for details p.67

# CHAPTER 8

## TAX AND LEGAL IMPLICATIONS FOR AN INSURANCE EXCHANGE

### INTRODUCTION

The consideration of tax and legal issues involved in the creation of an Insurance Exchange proceeded on the basis that the Exchange would be primarily a self-regulating body and would have to operate on a Canada-wide basis and would have to accommodate both Canadian and foreign business in order to be viable. In addressing these issues, it was assumed that the Insurance Exchange would be established by a Special Act of the Province of the Ontario Legislature and that the support and co-operation of the federal government and all provincial jurisdictions would be forthcoming in the resolution of tax and legal matters involved in the formation and operation of the Exchange in accordance with the foregoing assumptions.

It is considered that, in addition to the Special Act of Incorporation, relatively minimal amendments to existing legislation would be required to permit the Insurance Exchange to operate within the general framework of existing laws in Canada. The areas in which amendments and clarifications would be required have been identified in general terms considered sufficient for this feasibility study but further studies and deliberations would be required on matters of detail if the project is to proceed.

### SPECIAL ACT FOR THE EXCHANGE

Assuming the Exchange will be brought into existence by a Special Act of the Ontario Legislature, the contents of the charter documentation and the by-laws of the Exchange will have to be determined. Consideration will also have to be given as to what matters are to be included in the charter itself and what matters will be dealt with in the by-laws, bearing in mind that any amendment to the charter would require further legislation.

A Special Act incorporating the Exchange should deal with the following:

(a) The name of the Exchange.

(b) The objects of the Exchange.

(c) The purpose of the Exchange (i.e. whether a non-profit organization or whether the Exchange will be carried on for the purpose of gain and whether any profits are to be used to promote its objects rather than being distributed).

(d) The head office of the Exchange.

(e) The establishment of a board of directors or governors, and the determination of representation on the board (i.e. between underwriter members, broker members, and the public at large).

(f) The method of electing board members.

(g) The powers given to the board of governors to govern and regulate the Exchange.

(h) Amendments to other Ontario legislation.

(i) Provision for guarantees, if any, by the Province of Ontario.

(j) The powers of the Exchange, including the power to hold land.

(k) The application of appropriate provisions of the Corporations Act (Ontario) or any successor thereto and of other relevant legislation such as The Insurance Act, The Securities Act and The Registered Insurance Brokers Act.

(l) The establishment of a guarantee fund, if any; and

(m) The powers of the Superintendent of Insurance.

Matters such as the following could be dealt with in the Exchange's by-laws:

(a) The qualification and the conditions of membership.

(b) The admission of any persons as ex-officio members.

(c) The fees and dues payable by and securities issued to the members.

(d) The issue of membership cards and certificates.

(e) The suspension and termination of memberships.

(f) The transferability of memberships and restrictions on the transferability if any.

(g) The qualification and remuneration of the directors and the ex-officio directors, if any.

(h) The time and the manner of election of directors.

(i) The appointment, remuneration, functions, duties and removal of agents, officers and employees of the Exchange.

(j) The time and place and the notice to be given for the holding of meetings of the members and of the board of directors, quorum for meetings, requirements as to proxies, and the procedure in all things at members' meetings and at meetings of the board of directors.

(k) Audit and reporting requirements.

(l) Establishment of a discipline committee.

(m) Capital and solvency requirements for members; and

(n) Procedures for self-regulation.

THE INSURANCE ACT (ONTARIO) AND THE REGISTERED INSURANCE BROKERS OF ONTARIO ACT

The Insurance Act, which applies to all insurance undertaken in Ontario and to all insurers carrying on business in Ontario, requires that all insurers undertaking insurance in Ontario be licensed under the Act. It is anticipated that the Exchange itself will not be undertaking insurance but rather will provide a facility for use by its member syndicates who will in fact be the persons undertaking insurance in Ontario. It is also anticipated that some of the syndicates of the Exchange will be comprised of or include members who will be individual persons. Those individuals would not qualify for licensing under the present provisions of The Insurance Act which contemplates only insurance corporations and does not contain any provision whereby individual persons may obtain a license to underwrite contracts of insurance and carry on business in Ontario.

The RIBO Act contains certain prohibitions regarding licensing and acquisition which effectively restrict the ability of international insurance brokers to carry on business in Ontario. None of the other provinces presently has any similar legislation.

The licensing problem will have to be dealt with and the following issues will have to be considered:

(a) Whether syndicate members of the Exchange will be licensed under The Insurance Exchange Act or be licensed individually under The Insurance Act.

(b) Whether The Insurance Act should be amended to permit the Exchange itself to obtain an umbrella license (as Lloyd's has) thus dispensing with the requirement for separate licensing of members.

(c) Whether restrictions regarding foreign ownership will apply to syndicate membership on the Exchange.

(d) Whether the Superintendent of Insurance should have a veto power over the syndicate membership and, if so, whether such powers should be discretionary, and what the appeal procedure should be, if one is required.

(e) The basis on which a broker or agent from outside Ontario can qualify for membership on the Exchange as a broker member.

The resolution of these issues may depend to some extent on the position taken by The Federal government and other provincial jurisdictions where licensing or license exemptions may be required in order that the Insurance Exchange and its members can transact insurance business on a Canada-wide basis.

## THE SECURITIES ACT (ONTARIO)

There are several activities to be conducted by the Exchange and its members which might possibly be construed as constituting trades and distributions of securities to the public, in particular:

(a) The solicitation of members by the Exchange.

(b) The solicitation of members by the syndicates.

(c) The issuance of bonds or debentures by the Exchange as a means of raising capital from members or through public offering.

(d) The issuance of shares to members of the Exchange, if in fact shares will be issued to the members.

Care should be taken to ensure that provisions of an Insurance Exchange Act would be compatible with The Ontario Securities Act. The recently introduced Toronto Futures Act can be regarded as a useful model for the drafting of The Insurance Exchange Act.

## LEGAL STATUS OF SYNDICATES

Technically, syndicates could take the form of corporations, partnerships or joint ventures. For reasons indicated below under "Tax Treatment of Syndicate Members", the success and viability of the Exchange will probably require that syndicates be constituted as joint ventures.

The creation in law of a syndicate, in the form of a joint venture and not a partnership, is a question of fact in all of the circum-

stances including the intention of the parties, the nature of the contribution, a joint property interest in the subject matter of the venture, the right of management of the enterprise, presence of a "venture", the right to participate in profits, the term of the venture, freedom of transfer of ownership interest, and so on.

Consideration should be given to amending The Partnerships Act (Ontario) to make it clear that a syndicate of the Exchange is a joint venture and not a partnership.

## FOREIGN INVESTMENT REVIEW ACT CONSIDERATIONS

Under the Foreign Investment Review Act ("FIRA"), a non-eligible (non-Canadian) person, or a group of persons any one of which is a non-eligible person, which proposes to commence a new business in Canada unrelated to an existing business of the person or group of persons, is required to obtain approval under the Act for the commencement of such new business.

A number of syndicates on the Insurance Exchange will likely include some members who are non-eligible persons for purposes of FIRA and the position might be taken that the syndicates, in underwriting a Canadian insurance risk, were commencing a new business in Canada. On the other hand, a syndicate might be regarded as a passive investor with the actual insurance business being carried on by a syndicate or insurance manager who did not require approval under FIRA for his management activities.

The Insurance Exchange itself, if constituted as a not-for-profit corporation, would not likely fall within the application of FIRA regardless of the make-up or status of its membership.

When the exact nature of arrangements relating to the Insurance Exchange and its syndicate members have been determined, the opinion of the Foreign Investment Review Agency could be sought to confirm the non-applicability of FIRA to the operations of the Insurance Exchange.

## OTHER LEGAL CONSIDERATIONS

The support of the federal government and other provincial jurisdictions may necessitate certain amendments to such of their legislation as may relate to the Insurance Exchange.

## TAX TREATMENT OF SYNDICATE MEMBERS

The most likely candidates for syndicate membership are Canadian and

foreign insurance companies, individuals, non-insurance corporations, and captive insurers. The taxation considerations for captives are explained below under Captive Insurers.

As a general rule, the tax position of syndicate members will benefit from a "flow-through" of the syndicate's financial results to each member in proportion to his participation. In the absence of some very special rules, this benefit will require that syndicates be unincorporated.

## Status of a Syndicate

As explained above, there is a very real question whether an unincorporated syndicate would be a partnership or a joint venture. In order to permit maximum flexibility to each syndicate member in his own tax affairs it is important that a syndicate be a joint venture. This consideration is sufficiently contentious that the matter would have to be settled with the Canadian taxation authorities, most likely through the advance ruling procedure, unless the matter is clarified through amendments to the applicable partnership acts.

## Canadian and Foreign Insurer Members

Canadian and foreign insurers who become syndicate members would be accepting risks in the normal course of their businesses and all of the normal Canadian tax rules for insurers would be expected to apply. No unusual results would be expected and no legislation changes required. Nonetheless, caution is advised for foreign insurers not already licensed in Canada as their licensing as syndicate members may well subject all of their operations involving Canadian risks to tax in Canada.

## Individual Members

The Lloyd's method of accounting (in which accounts are closed three years after the commencement of the fiscal year) is currently accepted by the Canadian taxation authorities with regard to the insurance activities of Canadian and foreign individuals for Canadian income tax purposes. This may be an administrative solution to the dilemna caused by the fact that the present Canadian insurance taxation rules apply only to insurance corporations.

The most practical resolution of the Canadian tax treatment of individuals who are syndicate members would be:

(a) For the syndicates to follow the Lloyd's method of accounting; and

(b) To obtain advance income tax rulings on behalf of individual syndicate members to the effect that Revenue Canada would accept the Lloyd's method as the basis for taxation.

If the basis for such ruling would be acceptable to the taxation authorities, no change to the income tax legislation would be necessary to achieve the desired objective.

### Status of Non-Insurance Corporation Members

At the present time there are no Canadian taxation rules for insurance activities of non-insurance corporations, nor is there any administrative practice in this regard. There are two possible solutions to this problem.

(a) Canadian governments could be asked to extend the insurance provisions of the taxing statutes to cover non-insurance corporations' insurance activities. While governments may have some sympathy with this suggestion, there may be other considerations that render this possible solution less than practical; time delay, concern about the revenue effect of deduction of insurance losses against income from other sources, and concern about the policy aspects and revenue effects as a result of deduction for warranties that might, in effect, be self-insured by syndicate members with other business operations.

(b) Canadian taxation authorities could be asked to extend the acceptability of the Lloyd's method to include the exchange operations of non-insurance corporations. In this case, the concern of government authorities would likely be limited to the possible revenue effects - which would in all likelihood not be very significant. This approach should be attempted first for practical reasons.

Unless an acceptable taxation solution can be found for non-insurance corporations, it is unlikely that they would participate as syndicate members other than through a captive Canadian insurance company.

## CAPTIVE INSURERS

The ability to attract captive insurers as syndicate members deserves specific comment from a taxation viewpoint. The term "captive insurer" in this context is understood to mean an insurer that is wholly-owned, or at least substantially owned, by another corporation

or corporations primarily for the purpose of insuring or reinsuring risks within the corporate group. Captives may be either Canadian insurance companies or offshore insurance companies.

The taxation of resident Canadian captive insurers is identical to that of other Canadian insurers in similar circumstances. Accordingly, their activities through an Insurance Exchange would not have unusual tax consequences.

However, the tax status of an offshore captive vis-a-vis Canadian risks and transactions is a very different matter. The structure, management and operations of offshore captives owned in Canada are very carefully devised to insulate both the Canadian owner(s) and the captive from immediate tax on the captive's operations. If such captives were to become syndicate members "licensed and strictly regulated" to do business in Canada through an exchange here, there is great likelihood that the captive's operations would become taxable in Canada. Since the Canadian taxation aspects are very important to offshore captives, other overriding considerations would need to be present to encourage their participation in a syndicate on an Insurance Exchange.

## SUNDRY TAXATION MATTERS

It is contemplated that non-income taxes such as provincial premium taxes and fire marshals' taxes would continue to be applicable to insurance placed through the Insurance Exchange on the basis of the location of the risk insured. In order to ensure that such taxes are handled appropriately on a routine basis, it is suggested that the Exchange act as an agent for its members in collection and/or paying of such taxes.

# CHAPTER 9

## CONCLUSIONS AND RECOMMENDATIONS

The conclusions and recommendations of the Insurance Exchange Advisory Committee respond to the Terms of Reference set out in the Order-in-Council establishing the Committee. They are based upon a critical study of the Canadian insurance and reinsurance markets, the experience of other Insurance Exchanges, and a review of the tax and legal considerations relative to the establishment of an Insurance Exchange. These findings result from the informed opinions of senior representatives of all segments of the Canadian insurance industry and related professions.

The Advisory Committee, while reviewing the insurance industry in the present, considered its historical development and looked critically at its future requirements and responsibilities with particular reference to the future insurance needs of Canada's industrial and commercial sectors. In its approach to determining the feasibility of an Insurance Exchange, the Advisory Committee stressed the focus such an Exchange should have and the conditions required for its success as a commercial venture.

The Advisory Committee agreed on the appropriateness of the timing of the feasibility study as a response to the changes and adjustments inherent in the growth of a Canadian insurance industry, but its deliberations were not influenced by any sense of critical urgency.

With over $8 billion of premium being generated annually, the Canadian general insurance industry holds an impressive position in the country's economy and yet it has no focal point or central marketplace in Canada. A significant portion of this premium volume is placed in markets outside Canada, giving rise, in some cases, to concerns regarding the security provided.

The Advisory Committee examined and considered carefully the cyclical nature of the insurance industry, the current climate of competitiveness and overcapacity and the present practices of placing risks in both insurance and reinsurance markets.

THE ADVISORY COMMITTEE, IN CONSIDERING ALL ASPECTS OF THE ESTABLISHMENT OF AN INSURANCE EXCHANGE, ITS PLACE IN THE CANADIAN INSURANCE INDUSTRY AND THE COUNTRY'S FINANCIAL STRUCTURE AND ECONOMY GENERALLY, CONCLUDED THAT AN INSURANCE EXCHANGE, BASED IN TORONTO, OFFERS SUFFICIENT ECONOMIC ADVANTAGES TO MAKE IT FEASIBLE AS A COMMERCIAL VENTURE AND THAT THE TIMING IS APPROPRIATE FOR ITS PLANNING AND STRUCTURE.

THE BASES FOR THE ADVISORY COMMITTEE'S RECOMMENDATIONS ARE:

- The recognition that through an Insurance Exchange the insurance industry would support the Government's objective of continuing enhance the financial services industry in this province.

- An Exchange will complement the insurance industry by providing centralized domestic market facility for the placement of large, complex and unusual risks.

- An Exchange will assist in bringing about orderly marketing in a more open market environment and thus bring benefits to consumer of insurance.

- An Exchange will provide a clearing house where experience, stat tical data and other pertinent information will be easily shared

- At present, the Canadian financial community takes relatively little interest in the general insurance industry. An Exchange would encourage the investment community to focus on the industr This scrutiny would be beneficial and, coupled with a comprehens investment rating system, could encourage the flow of new capita to the industry.

- An Exchange will provide major brokers with a vehicle to attract international risks to the Canadian market.

- An Exchange, through the training of specialists, will promote t growth of Canadian expertise in specialized, complex and international insurance. In time, Toronto would be added to the majo world property/casualty insurance centres of London and New York

- The prestige of an Exchange will encourage the placing of more reinsurance domestically and gradually stem some of the outflow of premium funds to foreign markets.

- The standards of conduct set by the Exchange including the promp settlement of claims, together with the security of a guarantee fund, will provide a high degree of comfort to insureds.

- The centralized processing facilities of an Exchange will make f cost-effective operations to the benefit of participating broker and underwriters and, consequently, the customers.

- As the Exchange grows in capacity and influence, it will provide underwriting leads to other markets both domestic and foreign.

- It is anticipated that initially the Exchange will attract mainl facultative rather than treaty reinsurance because it will take time for the Exchange to prove its merits and to change establis relationships. The Exchange should become an attractive facilit for negotiating facultative reinsurance because of the one-stop

shopping or "room" concept, making it possible to complete the placing in one location.

- As expertise develops, the Exchange will compete for specialty risks.

- An Insurance Exchange will assist the Canadian insurance industry in responding to the growing demands that are being placed upon it by the expanding economy; the upward spiral of values, particularly in high technology products, and the requirements of specialized and mega project risks.

- After careful consideration we are satisfied that all tax and legal matters can be resolved satisfactorily.

- The federal government's proposal for changes in the ceding of reinsurance, if adopted, will have a favourable impact on the Exchange.

- Presently, about 25 percent of the reinsurance placed by Canadian insurance companies is ceded to non-registered reinsurers outside Canada. An Insurance Exchange will provide a domestic alternative for placement of such reinsurance, thus providing greater security to both the insurers and the insuring public.

THE SUCCESS AND GROWTH OF AN EXCHANGE WILL DEPEND ON:

- The willingness of the insurance industry to participate in the Exchange. In our view there is a reasonable expectation of such participation but positive support by way of commitments from the members of the industry during the formative stage is essential.

- The executive leadership provided from the outset to ensure that momentum and direction are maintained.

- The quality and efficiency of its operations.

- The extent to which brokers and syndicates will assign experienced and knowledgeable personnel to the Exchange.

- While the key to its success will be the volume of premium offered by the major brokers and reinsurance intermediaries, an Exchange would be available to all agents and brokers, either as associate brokers or through an association broker membership, for placing risks which because of their size or unusual nature cannot be underwritten through their usual markets.

- The cooperation and support of the federal and provincial governments to ensure that the Exchange is national in scope.

- The amount of new capital an Exchange will attract and thus increase the capital base of the industry.

- The self-regulating aspect of the Exchange which will encourage innovative approaches to marketing and attract venture capital to syndicates.

WE WOULD LIKE TO CAUTION THAT:

- An Exchange would not be a panacea for all the problems facing the Canadian insurance industry.

- The growth of an Exchange would be gradual and dependent on the reputation it will earn over time.

- An Exchange should not seek preferential tax or regulatory treatment to the disadvantage of present members of the insurance industry.

THE ADVISORY COMMITTEE SEES ENOUGH POSITIVE SIGNS FOR THE CREATION OF AN INSURANCE EXCHANGE AND THEREFORE RECOMMENDS THAT THE GOVERNMENT AUTHORIZE WORK TO BEGIN ON PHASE II -- IMPLEMENTATION STUDIES INTO THE LEGISLATIVE FRAMEWORK, THE MANAGEMENT AND ADMINISTRATIVE STRUCTURE AND LICENSING REQUIREMENTS OF AN EXCHANGE.

WE ARE OF THE OPINION THAT AT THIS STAGE THESE STUDIES CANNOT BE UNDERTAKEN ON A VOLUNTARY BASIS AND THAT FUNDS WILL HAVE TO BE ALLOCATED.

THERE ARE COMPELLING REASONS FOR THE ADVISORY COMMITTEE AND THE SUB-COMMITTEES TO BE KEPT INTACT THROUGH PHASE II TO ENSURE THAT THE KNOWLEDGE GAINED BY THESE COMMITTEES CONTINUES TO BE AVAILABLE.

RECOGNIZING THAT NEW APPROACHES ARE THE KEY TO THE CONTINUING STRENGTH AND GROWTH OF THE INSURANCE INDUSTRY IN CANADA, WE EXPRESS OUR APPRECIATION FOR THE RESPONSE GIVEN BY THE GOVERNMENT OF ONTARIO IN ESTABLISHING THIS COMMITTEE AND FOR THE OPPORTUNITY OF SERVING ON IT. ALL MEMBERS RECOGNIZED THAT OUR TASK WAS OF GREAT IMPORTANCE TO THE PROVINCE AND TO THE INSURANCE INDUSTRY, AND WE WELCOMED AND ENJOYED FACING THE CHALLENGES IT PRESENTED.

OVERVIEW OF FOUR INSURANCE EXCHANGES

| SUBJECT | LLOYD'S OF LONDON | NEW YORK INSURANCE EXCHANGE | ILLINOIS INSURANCE EXCHANGE | INSURANCE EXCHANGE OF THE AMERICAS |
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| ACTS AND BY-LAWS | Society of Lloyd's<br>Society is governed by a Deed of Association<br>August 13, 1811<br>Lloyd's Acts: 1871 made Society a legal entity as the Corporation of Lloyd's<br>Lloyd's Acts: 1911<br>1951<br>1982<br>The Corporation of Lloyd's does not accept insurance, nor does it assume liability for business transacted by members. It provides the marketplace and supporting services. | Insurance Exchange<br>a not-for-profit corporation<br>Regulations issued by the Insurance Department of the State of New York.<br>Insurance Exchange is self-regulating entity under the overall supervision of the Insurance Department. | Insurance Exchange<br>a not-for-profit corporation<br>The By-laws of Illinois Insurance Exchange are part of the Illinois Insurance Code.<br>Partial list of headings:<br>Offices: located in State of Illinois.<br>Voting Rights: Election of Board of Trustees. Voting by ballot.<br>Annual Meeting:<br>Quorum:<br>Vacancies: shall be filled by Board.<br>Compensation for Trustees:<br>A fixed and expenses of attendance.<br>Charges in Ownership of Syndicates<br>Arbitration:<br>Disciplinary actions:<br>Amendments: | Insurance Exchange<br>a not-for-profit corporation<br>The bulk of the Insurance Code 5.629.401 does not apply to the Exchange (form and rate requirements).<br>Any amendments to the constitution and the by-laws are subject to Commissioner's approval.<br>The Department issued the following powers and duties:<br>. examination<br>. approval of members<br>. investigation of members applications<br>. receive notice of management changes<br>. loss reserves<br>. distribution of profits limited to 30% of surplus in any year. |
| EXCHANGE OPENED | Lloyd's Coffee House about 1688 | Exchange created: by New York State Act in 1978<br>Came into existence: July, 1979<br>Opened for business: March 31, 1980 | Opened for business: November 20, 1982 | Opened for business: 1983 |

| SUBJECT | LLOYD'S OF LONDON | NEW YORK INSURANCE EXCHANGE | ILLINOIS INSURANCE EXCHANGE | INSURANCE EXCHANGE OF THE AMERICAS |
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| ORGANIZATION STRCUTURE | Council of Lloyd's (1982)<br>. is a governing body<br>. 16 working members of the Council elected from among the working members of the Society<br>. 8 external members of the Society elected from external members of the Society<br>. 3 nominated members of the Council by the Council confirmed by the Governor of the Bank of England<br>Power of Council:<br>Manage, supervise and regulate the business according to the by-laws established by the Council, making provisions for and regulate the admissions, supervision and disciplining members.<br>The Council may delegate some powers to the Committee. | Board of Governors<br>12 members responsible for overall management and direction of the Insurance Exchange:<br>. 6 representing underwriters<br>. 2 representing brokers<br>. 4 public representatives:<br>No person affiliated with syndicates or brokers can become a Public Governor<br>The Board is assisted by Advisory Committee of volunteer professionals. | Board of Trustees<br>13 members responsible for administrating and regulating the Insurance Exchange:<br>. 6 to 8 elected by Underwriting Syndicates.<br>. 1 to 3 by Brokers<br>. 4 are "public" trustees (not affiliated with brokers, syndicates or insurers) elected by both brokers and underwriting syndicates. | Board of Governors<br>No less than 6 but no more than 13: One-third will be public representatives nominated by: syndicates, brokers, State Governor. Majority must be U.S. citizens. |
| | Committee of Lloyd's<br>The working members of the Council constitute the Committee. The Committee elects annually a Chairman and two Deputy Chairmen who head a staff of 2,000. | Exchange Staff:<br>President and Chief Executive Officer - responsible for day-to-day operations of Exchange supported by staff. | Exchange Staff:<br>Executive Director who reports to the Board of Trustees and is supported by technical, clerical staff. | Exchange Staff:<br>President and Chief Executive Officer - supported by staff. |

| SUBJECT | LLOYD'S OF LONDON | NEW YORK INSURANCE EXCHANGE | ILLINOIS INSURANCE EXCHANGE | INSURANCE EXCHANGE OF THE AMERICAS |
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| CLASSES OF MEMBERSHIP | Syndicates -<br><br>Society members accept insurance risks for their personal profit or loss and are liable to the full extent of their private fortunes to meet their insurance commitment.<br><br>Five year experience required. Members (Names) have to pass a wealth test: £50.000. Percentage of net worth is deposited with Lloyd's.<br><br>"Names" (those who work at Lloyd's or are sons and daughters of Lloyd's members) require £25,000 net worth.<br><br>U.K., E.E.C., Commonwealth citizens residing outside U.K. ("Names") - £100,000. Foreign Nationals - £135,000. | Syndicates -<br><br>Limited liability.<br><br>Classes of Syndicates:<br>Non-life syndicates<br>Life syndicates<br>Combination syndicates<br><br>An underwriting member of Exchange cannot write a policy in which the insured does not have an insurable interest.<br><br>No licensed insurer can become a syndicate - can only own a share in a syndicate.<br><br>No broker member may invest more than 20% in a syndicate and vice versa.<br><br>Captives can participate as investors in syndicates or assume third-party business from NYIE Syndicates. | Syndicates -<br><br>Limited liability.<br><br>Are corporate entities, each represented by a qualified underwriting agent(s). | Syndicates -<br><br>Limited liability.<br><br>Can be corporations, partnerships, or individuals who write through underwriters. |
| | Underwriting Agents -<br><br>Manage the syndicates:<br>. Underwrite contracts of insurance<br>. Reinsuring such contracts<br>. Paying claims<br><br>Specialist Underwriters -<br><br>Are known as "Leaders" for their specialty line. Broker seeking to place a risk will try to get a leader to be first to accept a share. | Underwriting Managers<br><br>Manage the syndicates and transact business for them.<br><br>Underwriting Deputies<br><br>5 years experience in insurance business. | Underwriting Agent(s)<br><br>Each syndicate shall designate one person as a Manager. All communication between Insurance Exchange and Syndicates shall go through him. | Underwriters - employed by Syndicates to provide insurance and reinsurance expertise. |

| SUBJECT | LLOYD'S OF LONDON | NEW YORK INSURANCE EXCHANGE | ILLINOIS INSURANCE EXCHANGE | INSURANCE EXCHANGE OF THE AMERICAS |
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| CLASSES OF MEMBERSHIP (cont'd) | Brokers - placing risk in the "Room" and negotiate rates of premium with specialist underwriters. A managing agent cannot act as a broker. | Broker Member:<br>Only licensed agents or brokers under N.Y. Insurance law who have practised at least three years, are eligible for membership.<br>Can submit any business eligible for Insurance Exchange. | Brokers:<br>Persons who are admitted to the Exchange to present applications for insurance and are licensed by the Director. Only brokers can present applications for insurance to a syndicate. | Brokers:<br>Licensed agent with 3 years experience. |
| | Associates:<br>Are technicians, lawyers, claim adjusters and actuaries. | Associate Broker:<br>Is permitted to transact business with the Exchange in only one of the following circumstances:<br>a) for associate's own account; no split of a commission;<br>b) Associate Broker must submit all other business to a broker member for placement on the Exchange.<br>Associate Brokers are not eligible to vote and are subject to specific criteria spelled out in the by-laws. | | Associate Broker:<br>Can operate only through brokers; have no voting rights. |
| | | | | Subscribers: will provide supplementary services. |
| | | | | Founder Members:<br>Insurance related professionals who have a direct initial involvement in the affairs and planning of Exchange, but no vote. |

| SUBJECT | LLOYD'S OF LONDON | NEW YORK INSURANCE EXCHANGE | ILLINOIS INSURANCE EXCHANGE | INSURANCE EXCHANGE OF THE AMERICAS |
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| CLASSES OF MEMBERSHIP (cont'd) | Agents - Network of agents throughout the world who provide news relating to their geographic areas. Approximate number: 2,000 | | | |
| | | Book of Records: The Exchange keeps official book of records, minutes of proceedings. | Book of Records: The Exchange keeps official book of records, minutes of proceedings. | Book of Records: The Exchange keeps official book of records, minutes of proceedings. |
| | Auditor Sets the levels of the reserves - approved by the Council. | Examination and Annual Statements: The Director of Insurance may examine financial records of Exchange members. | Examination and Annual Statements: The Director of Insurance may examine financial records of Exchange members. | Examination and Annual Statements: The Director of Insurance may examine financial records of Exchange members. |
| | Disciplinary Committee | | | |
| | Appeal Tribunal | | | |

| SUBJECT | LLOYD'S OF LONDON | NEW YORK INSURANCE EXCHANGE | ILLINOIS INSURANCE EXCHANGE | INSURANCE EXCHANGE OF THE AMERICAS |
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| MEMBERSHIP | December 1982<br>"Names": 21,601<br>Syndicates: 300<br>Brokers: 272 | December 1982<br>Syndicates: 35<br>Underwriting Managers: 21<br>Brokers: 61<br>Associates: 25 | November 1982<br>Syndicates: 7<br>Brokers: 34 | September 1982<br>Syndicates: 10<br>Brokers: 33 |
| ELIGIBILITY | Conditions of eligibility are spelled out in the Act 1982 by-laws, example:<br>Means test<br>5 years experience, etc. | International in scope<br>Members of the syndicate are <u>not</u> required to have insurance expertise.<br>Qualification requirements stated in the by-laws | Any licensed broker can apply.<br>Members of the syndicate are <u>not</u> required to have insurance expertise.<br>Qualification requirements stated in the by-laws | Any licensed broker can apply.<br>Members of the syndicate are <u>not</u> required to have insurance expertise.<br>Qualification requirements stated in the by-laws |

| SUBJECT | LLOYD'S OF LONDON | NEW YORK INSURANCE EXCHANGE | ILLINOIS INSURANCE EXCHANGE | INSURANCE EXCHANGE OF THE AMERICAS |
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| PROTECTION OF POLICYHOLDERS | Members' Premiums Trust Funds<br><br>Premiums and other receipts held in Members' Premium Trust Funds and are available for the payment of claims and expenses.<br><br>At December 1981:<br>U.K. - £3,300 million<br>U.S. - $3,500 million<br>And<br>Canada - $265 million<br><br>Deposits and Underwriting Reserves are held in trust by Lloyd's as security and are released only after all members' underwriting liabilities have been reinsured by other Lloyd's underwriters. Deposits and Underwriting Reserves at December 1981: £600 million<br><br>Central Fund<br><br>Member's levy on premium income.<br><br>The Society holds funds for the following purposes:<br><br>. expenses of the Society<br>. for making good any default by a member<br>. for guaranteeing obligations of the Society<br><br>Size of Fund: approx. £120 million | NYIE Security Fund, Inc.<br>not-for-profit corporation<br><br>Separate from NYIE and administered by a Board of Directors elected by Syndicate Members. It consists of two funds:<br><br>1. Deposit Fund - consists of a $500,000 deposit from the capital and surplus of each Syndicate Member. It is designated for the benefit of the Security Fund, if it becomes depleted. Board of Governors can assess additional $500,000 to reconstitute the Deposit Fund.<br><br>2. Surcharge Fund of the Security Fund, assessment 3/4 of 1% of premiums written.<br><br>At the end of '82, the Security Fund totalled $18 million.<br><br>The fund is charged with the responsibility of assisting in the detection and prevention of insolvency and to recommend action to the Board of Governors. | Illinois Insurance Exchange Immediate Access Security Association,<br>not-for-profit corporation<br><br>It exists for the protection of policyholders: to marshall and disperse the assets of any insolvent member syndicate.<br><br>All syndicates, as a condition of membership in the Exchange, are participants in both the:<br>1. Immediate Access Security Fund<br>Totalling at least 50% of the syndicates' capitalization. In the event syndicates become insolvent, its trust account is taken over by the Immediate Access Security Assoc.<br><br>2. Guaranty Fund which exists for the payment of insurance claims against insolvent syndicates in the event its trust account is insufficient to discharge its claims.<br><br>Additional Assessment<br><br>of Syndicates, can be authorized, but it shall not exceed 3% of the net written premium by the syndicate in the last year. | Security Fund,<br>not-for-profit association<br><br>Each underwriting member will deposit $500,000 with the Insurance Exchange, plus 1% of premium underwritten by each syndicate. |

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| CAPITALIZATION | The share capital of ₤4,000,000 is subscribed by underwriting members of Lloyd's through the medium of their Premiums Trust Funds.<br><br>Amount of capitalization varies according to the volume of business. | Syndicate:<br><br>$3,550,000 for property/casualty<br><br>$6,550,000 if life, accident and health is included.<br><br>Limited liability. | Syndicate:<br><br>At least $2,000,000 of which 75% may be satisfied with acceptable letter of credit.<br><br>Limited liability. | Syndicate:<br><br>$1,500,000 for limited underwriting<br><br>$3,000,000 for full line including life, accident and health insurance in annuities.<br><br>Higher capitalization is permitted. |
| INITIATION FEE | | <u>Initiation Fee</u><br><u>Brokers</u> $ 10,000<br><br><u>Surety Bond</u> $ 40,000 | <u>Initiation Fee</u><br><u>Syndicate</u><br>Application fee $ 250<br>Initial assessment: $9,000 | <u>Initiation Fee</u><br>Syndicates $ 12,500<br>Brokers $ 6,000<br>Founding Member $ 5,000 |
| ANNUAL FEE | | <u>Syndicate Dues</u> $ 10,000<br>Assessment based on each Syndicate's Gross Premium invoiced by the Exchange in 1981-82 period.<br><br>Maximum $4,000,000: $60,000<br>$8,000,000: $80,000<br>over : $100,000<br><br>Box rental $ 8,000<br><br><u>Brokers</u> Dues $ 4,000<br>Assessment $1,500 - $25,000<br><br><u>Associate Brokers</u><br>Dues $ 1,000<br>Assessment $1,500 - $12,500 | <u>Syndicates</u><br>Annual fee $ 750<br>Annual assessment $10,000<br><br><u>Brokers</u><br>Annual fee $ 1,000 | <u>Syndicates</u> $ 10,000<br><u>Brokers</u> $ 5,000<br><u>Founding Member</u> $ 5,000<br><br>Assessed by the Board of Directors annually. |

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| TYPE OF BUSINESS | Insurance of every description excluding financial guarantees.<br><br>Long-term life insurance cannot be underwritten because of changing composition of Syndicates.<br><br>Lloyd's Life Assurance Ltd. established in 1971 writes long-life policies. It is separate from Lloyd's of London operations. | Reinsurance of all kinds, domestic and international.<br><br>Direct business of all kinds outside of the United States. Minimum premium of $100,000.<br><br>Direct New York business rejected by the Free Trade Zone.<br><br>Direct excess/surplus lines business from 22 States. | Reinsurance of all kinds, domestic (24 States) and international, except life.<br><br>Direct business of all kinds outside of the United States.<br><br>U.S. risks over $50,000 premiums and risks with premiums below that amount if declined by the licensed market in the State of Illinois.<br><br>Direct excess/surplus lines business from 21 States. | Reinsurance of all kinds, domestic and international.<br><br>Direct business of all kinds outside of the United States.<br><br>Florida excess/surplus lines business.<br><br>Any marine, aviation or transport business. |

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| RISK RETENTION LIMITATIONS | | The net liability per risk of an Underwriting Member shall not exceed 10% of its total capital and surplus to policy holders on the date of its last quarterly financial report.<br>T e total amount of reinsurance premiums ceded by one Underwriting Member shall not exceed 50% of gross written premium income for the year.<br>No Underwriting Member shall by a contract of reinsurance cede an amount of its business on which the total gross reinsurance premiums are more than 50% of the unearned premiums on the net amount of its insurance in force at the beginning of a 12 month period. (see By-law 12.50 p.15) | Maximum retention per risk is 10% of its liability per risk and at least 25% of its gross annual written premiums. | Risk retention per risk is 20% Acceptance of risk by a Syndicate is limited to 10% of its surplus to policy holders. Additional risk can be written only if the ratio of risk premiums to surplus does not exceed 8.5 to 1. |
| TAXES | Members may transfer profits for closed years to a special reserve fund for future underwriting losses at concessionary tax rates. | 10% excise tax to buyers who use non-admitted markets; NYIE is such a market for Canadians - This is Canadian Tax. | No premium tax on risk placed on the Exchange. | A premium tax of 2% on direct premium risks located in Florida. Syndicates formed off shore insuring off shore risk are free of federal income taxes.<br>See for detail - Peat Marwick Guide. |
| FUNDING | | Exchange issued $2.4 mill Subvension Certificates at 6% to finance long-range capital needs. | | |